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VERTICAL COORDINATION VIA CONTRACT FARMING

MISCELLANEOUS PUBLICATION NO. 1073
ECONOMIC RESEARCH SERVICE
U.S. DEPARTMENT OF AGRICULTURE

Miscellaneous Publication No. 1073

VERTICAL COORDINATION VIA CONTRACT FARMING

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For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price 65 cents (paper cover)

ACKNOWLEDGMENTS

Most of the research reported in this volume was completed at the University of Iowa under the general guidance of Dean Mason Ladd, College of Law (now Dean of the Florida State University College of Law), and the immediate supervision of Professor John C. O'Byrne, Director of the Agricultural Law Center (now Professor of Law, Northwestern University School of Law). Faculty members of the College of Law who participated in major parts of the legal research and prepared much of the legal material were Associate Professor N. William Hines, Assistant Professor Richard F. Dole, and Assistant Professor Jeffrey O'Connell (now Professor of Law, University of Illinois). Student research assistants contributed effectively to various aspects of the research. The authors particularly appreciate the contributions of Gene Wunderlich, Natural Resource Economics Division, Economic Research Service, U.S. Department of Agriculture, to an evaluation of the classification by selected statistical techniques.

Washington, D.C. March 1968

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VERTICAL COORDINATION VIA CONTRACT FARMING

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CHAPTER 1. INTRODUCTION

This report is based on research accomplished under Research and Marketing Act Contract No. 12-14-100-2636(43) between the U.S. Department of Agriculture and the University of Iowa College of Law. Under the contract, the University of Iowa agreed to plan and conduct a legal-economic study designed to describe, analyze, classify, and evaluate the provisions of contracts by which vertical coordination in farming is accomplished; to illustrate the purposes, strengths, and weaknesses of alternative forms of contractual relationships in the production process; and to provide information and data thereon for use as a working tool in economic and legal analysis to improve contractual arrangements for coordination of agricultural production.

The report is intended to furnish needed insight into the legal-economic nature of farming under vertical coordination contracts and the overall legal-institutional milieu in which such contracts are negotiated and performed. The aim is to present the first overview of the legal-economic nature of contract farming and to provide the practicing lawyer and legal scholar with an awareness of economic aspects of contract farming and to give the advising economist and economic researcher a deeper understanding of the legal-institutional framework surrounding vertical coordination contracts.

Agricultural production has undergone more far-reaching change and made greater advancement during the last two or three decades than during all preceding history. Technological progress has been accompanied by legal-institutional adjustments, although at a slower pace. One major adjustment that has facilitated the introduction of new technology and promoted economic growth has been improved coordination between farm and off-farm firms. Recently, the most spectacular growth in coordination occurred in contract arrangements between farm and off-farm firms.

Over many decades, division of the production and marketing of farm products among numerous firms resulted in a multiplication of legal-economic relationships between farmers and off-farm businessmen. Some of the relationships established in practice were adjudicated at law. Existing law was adapted to the emerging situation, and new laws were fashioned to meet new requirements. As legal relationships became more predictable, the parties knew (within limits) their respective rights and duties under various types of coordination arrangements. Further development of the law facilitated the growth of complex economic relations, and these in turn called for still further development of the law. The legal and economic systems continued to make progress side by side, reacting to a rapidly growing technology and an ever-increasing demand for agricultural commodities.

As specialization subdivides the commercial production process into additional stages and permits more firms to enter the process, the relationships between the numerous firms assume greater significance, and the laws that govern these relations and the institutional setting in which such transactions occur become critical.

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The numerous steps in production that concern the farmer may be condensed to (1) acquiring the input (seeds, plants, or animals), (2) producing the commodity (all stages of raising a crop or feeding livestock--whatever is done on-farm), and (3) marketing the output (everything that happens in the marketing process between the farmer and the first purchaser of the product). Coordination of these steps can be achieved through several means that differ in the kinds of economic and legal relationships created. The four principal ways of achieving vertical coordination include open-market competition, farmer cooperatives, coordination within one firm, and contract farming.

A farming contract between the parties is drafted, executed, and performed in a legal framework within which the meaning of its various provisions is interpreted and which provides remedies in case either party fails to perform according to the agreement. Of concern is whether rights and duties of the parties are set out in a contract, either in great detail or only briefly, or whether they are left generally to implication under rules of law applicable to such contracts. Whether a contract is oral or written, the parties make their own interpretations or come to an agreement about their respective rights and duties, unless an insoluble controversy is taken to court. In case of a controversy, society provides a system of courts to interpret the provisions of the contract in light of applicable law.

Information on the interwoven and interdependent legal and economic aspects of vertical coordination via contract farming is slowly but systematically being assembled, analyzed, and evaluated in form for general use. One outstanding effort is Ewell P. Roy's Contract Farming, USA, which seeks" . . . to bring together into one source all the available materials for a unified, logical presentation. . . ."[1]

A number of other studies were undertaken in the last few years to provide the necessary information for participating farmers, off-farm contractors, farm leaders, farm organizations, credit institutions, farmer cooperatives, legislative bodies, and various public agencies concerned with agriculture. One of the landmarks is the product of the Pioneering Research Group of the Farm Economics Division, Economic Research Service, U.S. Department of Agriculture. Ronald L. Mighell and Lawrence A. Jones examined vertical coordination with care and in detail in an attempt to place the new forms in balanced perspective, to discover basic principles, and to develop relevant theory that would facilitate research on specific problems.[2]

Shortly after the beginning of the Mighell-Jones study, the project reported here, with a significantly different orientation, was initiated. It was a legal-economic investigation, whose basic objective was to increase the knowledge and understanding of what is really involved, legally and economically, in the change from a relatively independent open-market operation to one that is coordinated vertically with an off-farm firm via a contract.

The middle or on-farm production phase, which is the center of attention in contract farming, was also the center of attention in the analysis. The farm production phase may be coordinated via contract backward with acquisition of inputs or forward with selling of products, or in both directions.[3] Whether farm decision making under contract production tends to shift toward the supplier of inputs, or the buyer of outputs, or remains with the farmer, depends on circumstances. In the early development of contracting in the broiler industry, for example, the supplier of inputs usually was the key decision maker. But as contracting expanded into other phases of the whole production process, decision making was shifted toward the processor or marketer of broilers.

The farm firm, as a separate production unit, buys or otherwise gains control over inputs, creates new products with them, and sells the resulting output. In contract farming, the farm firm is concerned chiefly with what takes place on the farm in the overall production process, and the contracting off-farm firm is concerned chiefly with supplying inputs to or accepting outputs from the farm firm or both. In this report, the word "Contractor" is used to indicate the off-farm firm and the word "Farmer" is used to indicate the farm firm.

The units of observation of the study were vertical coordination contract forms in use at the time the study was undertaken. Data were not assembled on oral contracts nor on written agreements entered into subsequent to the effective date of a written contract. Contract forms were obtained from several hundred off-farm initiators. These were augmented by forms obtained

from the U.S. Department of Agriculture and Land Grant Colleges. From this collection, totaling approximately 900 contract forms, 420 were selected as representative of major agricultural commodities produced under vertical coordination contracts in different geographic areas. (See appendix for discussion of the selection of forms and their preparation for analysis.)

Chapters 3 to 10, inclusive, of the report describe the legal-institutional structure within which contracts are executed, performed, and enforced, and the legal effect of the arrangement. These chapters focus on the value of written contracts in relation to oral agreements, methods of contract modification, responsibilities imposed by the various types of legal relations, types and disclaimers of warranties, interrelatedness between title and risk of loss of both the input and the product, solutions in case performance is frustrated, unconscionable contracts, remedies for breach of contract, and various ways of establishing and maintaining security interests in contract inputs and products. The final chapter introduces a classification system developed to measure the shift of entrepreneurship from farm producers to off-farm firms and elucidates the nature of vertical coordination contracts based on selected classification criteria. In conclusion, it presents some ideas that could be helpful in future research.

FOOTNOTES--CHAPTER 1

[1] Preface. Interstate Printers and Publishers, Inc., Danville, Ill. 1963.

[2] Economic Research Service. Vertical Coordination in Agriculture. U.S. Dept. Agr., Agr. Econ. Report 19, 1963.

[3] For a more complete discussion of coordination backward and forward, see Hirsch, W. Z., Toward a Definition of Integration. Southern Economic Journal 17: 159-65, Oct. 1950.

CHAPTER 2. CONTENT OF THE CONTRACTS

The generalized picture of the content of vertical coordination contracts presented in this chapter sets the stage for (1) an examination of relevant law and (2) an exploration of ways of classifying the 420 contract forms for more detailed description and analysis.

The legal and economic provisions of the contracts may be grouped under five major headings: General provisions, including contract parties, contract forms, contract signers, and length of term of the contracts; farm and nonfarm inputs, covering land, buildings, special facilities, and labor inputs, but with emphasis on inputs furnished by off-farm firms; production process, including management decisions and standards of husbandry; marketing phase, encompassing problems of delivery, standards of quality, methods of marketing, provisions on pricing, and arrangements for payment; and contract enforcement, including oral modification, waiver of provisions, right to assign, time-is-of-the-essence provisions, remedies, warranties and liabilities, security devices, and obligations and excuses for failure to perform according to the contract terms.

GENERAL PROVISIONS

Contract Parties

Only two parties were usually mentioned in the contracts--Farmer and Contractor. Most of the Farmers were individual family farmers who owned and operated the businesses themselves, although sometimes the Farmer was involved in a partnership, a corporation, or some other form of co-ownership. Some also rented rather than owned their farms. A few neither owned nor rented the livestock, machinery, and special equipment used to produce the product under the contract--the Contractor furnished some or all of these items. Most of the off-farm parties were corporations, and a few were cooperatives.

In most contracts, no legal name was given for the relationship between contractor and producer. When reference was made to a legal status, it was usually to deny the existence of a particular relationship, such as employment, partnership, agency, or joint venture. Some contracts contained provisions about the relationship between the Farmer and his own employees, drivers of delivery vehicles, or migrant workers. A few specified that the Contractor was an agent of the Farmer for certain purposes, such as delivery or sale of the products or employment of laborers.

Contract Forms

Most of the contract forms were concerned with only one product. A few were drafted so the name of the product could be inserted, but only a small proportion of these apparently were to be used for more than a single product. The tendency seems pronounced for contracts to be tailor-made for each commodity.

Usually, the Farmer was confronted with a contract form in which standard provisions were the same as those presented to his neighbors. The blank spaces left to be filled in were designed to fit some provisions to each Farmer's unique situation.

A few standard contracts drafted by trade associations for members' use were included in the sample. Frequently, trade associations of fruit and vegetable canners drafted contracts for use by all member Contractors; and many trade associations apparently revised contract forms to increase similarities among contracts prepared by individual members.

Farmers' bargaining associations were involved in drafting some contracts; however, the associations, like the individual farmers, were frequently confronted with a contract drafted by the Contractor. Contract

approval by bargaining associations was most common in production of sugarbeets and fruits and vegetables in the West.

All dealers of large manufacturers or hatcheries usually used the same form, with a place for insertion of the dealer's name as the Contractor. Because only blank contract forms were studied, information about the Contractor was not available in these cases.

The most frequent dates appearing on the contract forms were 1959 and 1960, the years during which most of the contracts were collected. However, dates printed on the contract forms may not reflect the actual date of drafting, but rather the date of reprinting. In other words, the contract may be essentially the same, year after year, but may be reprinted periodically with a new date. Almost half of the forms did not have dates. The few contract forms drafted prior to 1957 covered products and geographical areas where contract production has long existed.

Contract Signers

Contracts that required only the Contractor and Farmer to sign were the most common. In all contracts, the farm operator was to sign as a party even though he was a tenant and not a landowner. In a few contracts, a specific officer of the Contractor was required to sign.

Some contracts called for additional signers; for example, a lienholder who had a security interest in the Farmer's property superior to that of the Contractor. If the lienholder subordinated his lien to the right of the Contractor, the special relationship between the lienholder and the Contractor usually appeared on the face of the contract.

Although some landlords were expected to sign as parties, usually a landlord's signature was to approve the contract or to release an interest. For example, a landlord, under the laws of his State or the provisions of the lease, or both, might release rights to a lien on property of the tenant for unpaid rents. The import of approval of the contract frequently was less clear. Although the landlord did not assume responsibility for production, by signing a contract he may have been promising the Contractor that he would comply with the terms of the lease vis-a-vis the tenant and would not oust the tenant during the period of the contract. Generally, the tenant was required only to specify his landlord's name and address.

Other provisions bringing third parties into the deal were usually one of three types: Provisions that call for the purchase of specified supplies from, or the sale of products to, named third parties; provisions that allow a cooperative or trade association to represent the Farmer or the Contractor, respectively; and provisions that specify the Contractor will furnish laborers who become employees of the Farmer.

Length of Term

The length of the contract period has notable legal and economic significance. The term of the contract may be either definite or indefinite. When the period is definite, each party can plan for the future with a high degree of assurance. If the term is based on an indeterminate future event or is subject to the decision of only one party, the planning horizon is obviously limited.

The effective date of most contracts was the date the Contractor and Farmer signed, but if other persons were required to sign as parties, all of the signatures usually were to be affixed before the contract became effective. A few contracts required approval of the home office of the Contractor before they were effective, and some livestock contracts did not become effective until a specified future date.

Generally, each contract stated a specific term or gave some method of determining it. Most contracts limited duration to one crop season, the growth period of one group of animals, or 1 year. Many contracts in the fruit and vegetable processing industry covered a period of one growing season and specified a date after which the Contractor would no longer accept the Farmer's products; livestock contracts were commonly written for the growing period of the particular animals; and broiler and egg contracts were generally for 1 year. In contracts for the production of broilers, several groups usually were to be produced and marketed in a 1-year period.

A few contracts provided for automatic renewal from period to period unless terminated by notice given by either party before a specified time prior to the end of the period. The base period was usually one season, production period, or year. A few poultry contracts continued until terminated.

Other contracts of indefinite duration were terminable under specific contingencies. For example, they could be terminated

because one party failed to perform or received a better price offer, or because some other condition occurred. Such contracts were found often in the production of commercial and hatching eggs.

Some contracts allowed either party to terminate the agreement upon notice to the other before actual performance began. Such provisions were most often found in canning contracts.

Farmers' contracts with cooperatives were often indefinite in duration, dependent on the Farmer's continued membership in the cooperative. Once a Farmer joined a cooperative and signed the membership agreement, usually he was bound by all the provisions of the group's charter and bylaws. Cancellation of membership by the Farmer had to follow the procedures outlined in the bylaws. Often a Farmer was permitted to resign from membership for the next year by a specific date each year. In some cooperatives, membership bound each member automatically to the production contracts of the type provided by the cooperative. In others, entering into a contract farming agreement was optional with members.

FARM AND NONFARM INPUTS

Cropland

Various terminology was used to describe the farm or land under the contract. Some contracts provided a blank for inserting the location of the farm; others simply referred to the Farmer's land or farm. A general reference occasionally was made to the entire farm, or a detailed description of a particular field was required. Fields were described by the rectangular system, or by words, maps, or sketches.

Crop production contracts often provided a place to insert the acreage of the crop. If more than one variety of the same crop was to be produced, the contract usually provided for stating the acreage of each variety. Specification of acres or fields was particularly important in contracts which provided that the Contractor could reject or refuse commodities produced on excess acres or on acres not subject to the contract.

Some contracts provided for indicating the quality of land to be used in very general terms, such as "suitable land"; in other contracts, a more specific quality standard was outlined. Particular types of land or fields, such as those fields used for the same product the year before, were sometimes declared "unsuitable."

Farm Buildings

Description of buildings furnished by the Farmer was called for most often in livestock production contracts. A few contracts set out the standards and specifications for buildings used in the production or marketing phases. A detailed description of buildings and storage facilities was frequently found in hatching and commercial egg-production contracts. These contracts stated that a certain number of square feet of floor space, feeding area, and nests were required for each 100 hens. Description of storage facilities for eggs sometimes set minimum standards. Storage facilities were specified in detail where storage was needed before delivery to the Contractor.

Whether the description of land and buildings should be regarded as warranties was not clear in many contracts, raising the following questions: If the Farmer's buildings did not meet the exact specifications, was a promise implied that he would reconstruct or add the necessary structures? Would it make any difference if the Contractor knew at the time of execution of the contract that the structures were not within the contract specifications?

The Subject-Matter Input

The contract forms usually contained definitive provisions regarding the input--seed, chicks, or trees--from which the commodity was to be produced (which we specify as the subject-matter input). The Contractor either furnished or was the source of these inputs in most cases. Some poultry contracts, however, specified a source other than the Contractor or Farmer for obtaining chicks. The fruit industry contracts were the only large group in which the Farmer was generally required to provide the subject-matter input--the trees.

The contracts generally specified in detail the number, amount, and kind of subject-matter inputs to be provided. When a Contractor handled more than one variety of crop or breed of animal, the contract

usually specified the variety or breed. No mention of variety or breed typically meant that the off-farm firm would provide its usual seed or stock, or that the variety or breed was optional.

In some contracts, the seed to be supplied by the Contractor was measured in terms of the quantity needed to plant the number of acres specified in the contract. When livestock were to be furnished by the Contractor, the number usually was stated in the instrument. Some contracts provided for control of the quantity of an input by clauses dealing with the maximum or minimum amount of the commodity to be produced. Such clauses were common in contracts for commercial or hatching eggs; for example, the number of laying hens was determined by the dozens of eggs desired.

Contracts in the sample seldom appeared to be designed to cover all of a farm's production capacity; but total coverage is known to be involved, for example, in those situations where a farm produced only one type of fruit or only eggs or broilers. Some contracts restricted the Farmer's right to grow like crops or animals apart from the contract obligation. Limitations also included provisions that the contract crop would not be grown within a certain distance of the Farmer's own crops of like variety; that contract and noncontract animals would not be fed and pastured together; that feed furnished by the Contractor would not be fed to noncontract animals; and so on. No contracts affirmatively stated that a Farmer could grow like crops or animals, but if the contract was silent, that right would be implied as long as it did not interfere with the Farmer's performance under the contract.

Numerous contracts specifically denied the Farmer the right to contract with others for like crops or animals. Less often, but not uncommonly, the contract provided that no contract for other products could exist.

Only in rare instances did a contract name the type of arrangement (usually a sale or a bailment) under which the subject-matter input was to be supplied. A sale was the norm, so generally a statement was necessary only for bailment.

Almost one-fifth of the contracts contained no clause stating how the Contractor was to be paid for inputs. Under most of the others, the Contractor was to be paid by a deduction from the Farmer's proceeds. Some livestock and poultry contracts required the Farmer to sign a note payable at market time, and in most of the seed contracts, the Contractor was to be repaid in kind by deduction from the marketable seed delivered.

About half of the contracts had clauses pertaining to either title or risk of loss of the inputs during the production phase, but only a few contracts included clauses covering both. Livestock, poultry, and seed contracts more often specified who held the title to the inputs, whereas fruit and vegetable contracts more frequently stated the party having the risk of loss.

Additional Inputs

Standard inputs such as customary machinery and power for planting, cultivating, and harvesting crops, or feeding and caring for livestock, were usually to be furnished by the Farmer, but occasionally the Contractor was to supply a part. Special equipment frequently was to be supplied by the Contractor, particularly if it was expensive. Labor usually was to be furnished by the Farmer. Special and migrant labor was to be supplied by some Contractors, or they agreed to make an effort to obtain it. Usually, such labor was to be paid for by the Farmer and considered in his employment.

Variable inputs, such as heat, electricity, and litter, were usually to be supplied by the Farmer. However, feed and feed additives might be supplied by either party. The Farmer frequently used his own farm-grown feed and bought the necessary supplements and additives. Inputs for controlling disease and pests and for promoting health, such as pesticides, insecticides, serums, vaccines, and veterinarian services, might be supplied by either party.

In many contracts, where the Contractor supplied inputs in addition to the subject-matter input, the Farmer was to pay cash at market time for these inputs. In other instances, although the Farmer was not charged directly for the inputs, the Contractor was to take into account the price of such inputs in making final payment.

THE PRODUCTION PROCESS

Management Decisions

Important provisions in many contracts were concerned with control over management decisions. Questions answered in the contracts included, for example: How much management decision making resides in each party? What types of decisions are made by Contractor? What techniques are used to control the decision-making process?

Contractors apparently followed one of two ideas in drafting the contracts. Under one idea, the Contractor reserved specific powers to himself, even though he did not intend to use all of them. Under the other idea, the contract set out a broad phrase giving the Contractor the right to assume decision making if a problem arose. The transfer of control under the first theory was concise and clear; the powers not mentioned were to be left in the Farmer. Under the second theory, the transfer of decision making was unclear; often it was difficult to determine exactly what control was to be transferred. Generally, the Farmer was free to make all decisions, except those agreed to in the contract or otherwise granted to the Contractor.

Contracts contained diverse methods for implementing decisions. For example, some contracts provided that the Farmer was to follow recommendations of the Contractor, to abide by the Contractor's instructions, or to submit to general supervision. Or, they provided that the Contractor could inspect, supply a fieldman to enforce the contract, or require records on contract performance. Record requirements were usually specified in the contract, but instructions to a fieldman were often left undetermined.

Operational decisions mentioned in the sample contracts varied considerably, especially with the type of product. Almost all livestock contracts shifted some control from Farmer to Contractor. Approximately three-fourths of the fruit and vegetable contracts had provisions specifying the party who was to make certain management decisions. In the production of vegetables, many more separate practices were subject to Contractor control than in livestock contracts. Usually, less control was to be transferred to the Contractor in the fruit industry than in the production of vegetables. Generally, when farm practices were mentioned, the Contractor had control of at least some of the most vital, such as dates of planting and harvesting and method of harvesting.

Standards of Husbandry

The off-farm Contractor may seek some minimum level of performance, but no really satisfactory technique has been discovered to state and guarantee such standards.

About one-third of the contract forms did not have any clauses specifying the standards of husbandry to be maintained. Another one-third specified standards in terms of general rules of good husbandry. In the remainder of the contracts, standards were to be maintained by the Contractor's supervision or his binding recommendations. Few contracts contained exact specifications of standards to be followed, except contracts for the production of seed.

MARKETING PHASE

Delivery of Product

Marketing provisions were crucial in many sample contracts. The Farmer was usually to be responsible for physical delivery of the product, although in some contracts, the Contractor agreed to load and haul the marketable product from the Farmer's premises to his own plant. Even though the Farmer had responsibility for delivery, in some cases the Contractor's transportation facilities were to be used, while in others they could be hired or rented at the Farmer's option. Cash costs of delivery might be the responsibility of one party, or might be shared by the parties.

Some contracts stated precise time for delivery; others left the decision to the Contractor; still other contracts indicated that the parties would mutually agree on delivery time when the product was ready; some stated that the delivery date would depend upon a specific future event. Time of delivery was usually stated either as a specific date, or in terms of weight, age, or stage of maturity.

Most often, the place of delivery was specified in the contract, although in some the place was to be decided later by the Farmer or Contractor, or by mutual agreement.

Standards of Quality

The standards that the commodity must meet when delivered at maturity were a subject of concern to both parties. Some contract forms devoted several paragraphs solely to quality measurement and control, covering size, color, texture, moisture content, and freedom from disease, injury, or damage. Over half of the contracts, however, had a general reference incorporating precise industry standards of quality.

Other contracts referred to Federal (USDA) or State standards of quality. Occasionally, a contract stated that acceptability of the product depended solely on the Contractor's judgment.

Most contracts contained clauses giving the Contractor the right to reject products which fail to meet quality standards.

Methods of Marketing

Many different methods of marketing were outlined in the contracts. If the Contractor was also a processor, the contract usually provided for mandatory purchase by the Contractor. If the Contractor was not a processor, the contract usually provided for a third-party buyer, whose name might be inserted in the contract, or provided that the Contractor would attempt to find a buyer. Occasionally, the Contractor merely had an option to buy the product, usually at a fixed price.

In almost all fruit, vegetable, and seed contracts, except those involving cooperatives, the Contractor was to buy or receive the product. Cooperatives, however, frequently were responsible for finding a purchaser of the Farmer's products. The Contractors in many livestock contracts assumed the responsibility of finding a purchaser. Generally, in fruit and vegetable contracts, the Contractor had an option to purchase excess or inferior quality products, or those maturing after a specified date, but was not required to do so.

Provisions on Pricing

Provisions on price may be the most important terms in a contract. In certain contract forms, the price was stated in specific, fixed monetary terms, while in others a method was outlined for future price determination. Where the price was fixed, a schedule frequently provided for variations in quality, such as a premium for high-quality and a discount for low-quality products. The price schedule in some contracts depended on the rate of gain, feed conversion ratio, or yield per acre; in other cases a bonus was given for meeting specified conditions. Some contracts provided for a minimum price and held out the possibility of a higher price, depending on delineated circumstances.

The price was stated occasionally in terms of the quoted price on a named market at a specified time. In some contracts, sugar beet contracts for example, the Farmer's price was related to the proceeds received by the Contractor after the product was processed and sold. In a few instances, the price was to be reduced if a crop was produced in excess of a stated quantity, or if the crop matured too rapidly for the processing plant to handle.

Some payments to the Farmer were to be made immediately upon receipt of the product, some at a later date. Occasionally, a partial payment was to be made at delivery and a final payment later. Some contracts provided that all of the Contractor's delivery boxes or crates must be returned before payment would be completed.

CONTRACT ENFORCEMENT

Oral Modification

Only a few contracts had provisions against subsequent oral modification. Some contracts contained statements specifically denying any agreements other than those appearing on the face. A few contracts had clauses incorporating both ideas.

Waiver of Provisions

A formal waiver, the voluntary relinquishment of a right, would not normally cause subsequent difficulty. Problems might arise, however, when one party claims a waiver of a condition by implication from an act of the other party.

A few contracts contained provisions denying that a condition could be waived. Technically, however, this denial is not effective, because the parties may agree to "waive" even the denial clause.

Provisions were found occasionally stating that a single waiver by the Contractor would not be deemed a waiver of a similar subsequent breach, or that a waiver of one requirement would not waive another. Such clauses allowed a party to waive a particular default without adversely affecting any other contract provision.

Right To Assign

In the contract forms, assignments to a third party of the interest of a signatory party were phrased in terms of (1) denial of certain assignment rights, (2) complete reservation of the right to assign, and (3) the binding effects of the contract on third parties.

Generally, vertical coordination contracts are assignable in the absence of a provision to the contrary. Approximately one-fourth of the contracts had provisions relating to assignment, and the majority of these were denials of the Farmer's rights to assign his interest in the contract. Restraints were more specific in others. Clauses appeared in some contracts reserving the Contractor's right to assign his interests.

Only a few contracts contained provisions relating to the agreement in event of death of one of the contracting parties. Statements of binding effect upon heirs, successors, executors, or administrators applied primarily to the Farmers because the Contractors were generally corporations. Even in the absence of such a provision, the Farmer's estate would generally be responsible for completing the contract.

Time of Performance

Time-is-of-the-essence provisions were included when punctual performance at the precise time named was vital to the agreement. In the case of canning peas, for example, the waste may be as high as 30 percent if the crop is harvested 4 days before its ideal maturity, while 5 days after the peak of maturity, the peas may be useless to the Contractor.

Remedies, Warranties, and Liabilities

Ordinarily, remedies available on breach of contract were not set out in specific terms since these remedies are part of the law within which the parties make their agreement. But some remedies would not be available unless the parties agreed in advance.

The most common remedial technique found in the contract forms, the "liquidated damages" clause, is not available unless it appears in the contract. Some Contractors maintained title in their inputs to facilitate repossession upon a breach of contract. Some contracts stated that inputs supplied to the Farmer would constitute a lien or preferred claim on the crops or livestock produced. A few contracts stated that sums owed on all inputs supplied to the Farmer were collectable as debts.

Warranties were usually given by the Farmer, and liabilities were usually disclaimed by the Contractor.

The Farmer's express warranties called for in the contract forms can be divided into five groups: Warranties that he (Farmer) had power or right to contract; warranties that the product would remain free of encumbrances; warranties that he would not destroy the product or sell it to third persons; warranties that he would not grow a like product for third persons; and warranties that he would abide by certain rules and regulations to assure the quality of the product. The second and third were the most usual warranties found in the contracts.

Generally, the Contractor could disclaim liability (1) for activities of his own agents; (2) for activities of the Farmer and his employees; (3) for pest control measures performed or suggested; (4) for failure to provide extra labor or equipment; and (5) for the quality of the input furnished.

Security Devices

Security devices in the contract forms were designed to secure the Contractor's investment in inputs and to assure that the Contractor would receive the product at market time. Provisions that the Contractor had the right to come upon the Farmer's premises and raise or remove the product if the Farmer defaulted were common.

Obligation To Perform

Some contracts included a rather extensive list of reasons for excusing the Contractor from performance. Generally, only limited reasons were given for excusing the Farmer, mainly "Acts of God" or natural causes.

When the Contractor was excused from performing, the relief usually took one of two forms: The Contractor was under no obligation to take delivery or pay for the products, or the Contractor was excused from performance to the extent he was unable to perform. When the Contractor was relieved of performance, the Farmer usually was freed of his promise to deliver the product, but he was not always relieved of the obligation to pay for inputs furnished by the Contractor.

The relief afforded the Farmer under the contracts included release from obligation to deliver the product, excuse from performing to the extent that he was unable to perform, and release from paying for nonfarm inputs. Performance prevented by an Act of God is protected under the law even without a contract provision to that effect.

Many contracts contained clauses that subjected the entire agreement to change automatically by and in accordance with subsequent Federal or State law.

CHAPTER 3. INTRODUCTION TO LEGAL PROBLEMS IN VERTICAL COORDINATION CONTRACTS

Contract law generally permits the parties to fix the scope of their legal rights and responsibilities by the contract terms, so theoretically the role of the law could be confined to providing remedies for breach of contract agreement. The parties to a contract, however, often do not definitively outline their respective rights and responsibilities, and consequently the law has formulated a number of rules considered applicable to a particular transaction unless the parties have expressly agreed otherwise.

These rules were originally developed by judges forced to resolve disputes between contracting parties. In 1906, many of these judge-made rules were cast into a proposed statute, the Uniform Sales Act, which subsequently was adopted by most State legislatures. Until the 1950's, the Sales Act was a major source of the legal rules applied to commercial contracts. In 1951, the Uniform Commercial Code was developed as a substitute for the Sales Act; since then, the Code has been revised several times, with the 1962 Official Text and Comments constituting the current authoritative version. The Uniform Commercial Code has been widely enacted and has generally supplanted the Uniform Sales Act as the source of legal rules applicable to commercial contracts. Both the Sales Act and the Code are discussed in this study.

The following overview of the principles of interpretation and construction, the parol evidence rule, and the doctrines of consideration and waiver should make clear that judges and legislators attempt to reach fair results in contract disputes. However, it also should make clear that prudent Farmers and Contractors will avoid costly and time-consuming litigation through reduction of their vertical coordination contracts to a written form which reflects their basic conception of the transactions; that they should carefully consider proposed contract language from the standpoint of their respective interests; and they should reduce any modification of written contracts to a similar writing that is supported by consideration where necessary. A written contract not only provides an accurate record of the understanding in case of later disagreement but also encourages careful thinking by the parties to a transaction.[1]

INTERPRETATION AND CONSTRUCTION OF CONTRACTS

The courts are frequently asked to determine the meaning of words and phrases used in contracts, especially where a complex commercial transaction is involved. The Uniform Sales Act only cursorily treats the subject of contract interpretation and more or less adopts the common-law position,[2] while the Uniform Commercial Code has more detailed statutory provisions.

The Uniform Commercial Code explicitly requires the parties to a contract to perform their promises in good faith.[3] Most non-Code States[4] also have good-faith rules, if only in the form of a judge-made principle of interpretation that if the words of a contract have more than one possible meaning, and one interpretation will make the agreement fair and effective, while the other will not, the former will be adopted.[5] This principle was, for instance, applied in a California case in which a contract for the sale of land provided that a deferred balance should be paid in installments as follows: "Mo. payments not exceed $25." The buyer sued for the return of his down payment, asserting that these words demonstrated that the amount to be paid had been left to future negotiations between the parties and that consequently there was an unenforceable agreement to agree and not a binding contract. Although the words were manifestly ambiguous, they were capable of the interpretation that the buyer promised to pay up to a maximum of $25 per month, depending on the sum requested by the seller. This interpretation was adopted by the court because it made the agreement

legally effective.[6] The California court also favored this interpretation because it coincided with the way in which the parties had acted under their contract before a dispute arose.[7]

Another generally accepted principle of contract interpretation is that the parties' understanding of their contract should be given considerable weight in interpreting unclear phraseology.[8] The Uniform Commercial Code refers to the manner in which the parties have performed a contract as a "course of performance" and the manner in which the parties have engaged in prior dealings as a "course in dealings."[9] Both are components of the set of factors which determine the meaning of the "agreement"[10] under the Code, and once again the Code clearly affirms traditional principles of contract interpretation.

Another standard principle of interpretation relates to trade usage or custom. It has long been recognized that proof of a local trade practice can establish the meaning of words or phrases in a contract.[11] In a New York case, for example, in the trade, the term "bbls" of sugar was shown to mean fine, granulated sugar weighing 350 pounds.[12] Similarly, a reference to "yearlings" in a Texas contract meant animals from 10 to 15 months old, according to custom.[13] A Michigan court allowed proof of trade usage to establish that "buy 3 May" in a contract meant the purchase of 3,000 bushels of May wheat.[14] The Uniform Commercial Code defines "usage of trade" as ". . . any practice or method of dealing having such regularity of observance in a place, vocation of trade as to justify an expectation that it will be observed with respect to the transaction in question,"[15] and states that usage of trade should be considered in interpreting commercial contracts.[16] Thus, the results in the above cases would have been no different had the Code been applicable.

Usage and custom ordinarily may be used to supply details which are not specifically mentioned in a contract.[17] For instance, where a contract for the delivery of one million bushels of barley failed to specify the manner of delivery, the court held that evidence of the customary mode of delivery was admissible, and the buyer was found justified in refusing to accept delivery of the barley loose in wagons because the customary method was to deliver it in sacks.[18] This principle of interpretation has been carried over by the Uniform Commercial Code. The drafters of the Code referred to usages of trade as the ". . . framework of common understanding controlling any general rules of law which hold only when there is no such understanding."[19] A clearer statement of the significance of trade usage under the Code could not be made. Trade usage is disregarded only where express terms to the contrary appear in the contract, where an inconsistent course of performance or course of dealing is evident, or where interpretation of the contract in light of relevant usage of trade would unfairly surprise the parties.[20]

Akin to the principles of interpretation applied in Code and non-Code States are certain principles of construction which the courts use to fill "gaps" in express agreements between the parties. If it is clear that the parties intended to conclude a binding contract, the courts are reluctant to frustrate their intention simply because some terms (even the all-important price term) of that contract are incomplete.[21] Thus, in one case the court held that the parties had intended that the goods were to be sold at a reasonable price.[22] The Uniform Sales Act similarly provides: "The price may be fixed by the contract, or may be left to be fixed in such manner as may be agreed, or it may be determined by the course of dealing between the parties. . . . Where the price is not determined in accordance with the foregoing provisions the buyer must pay a reasonable price. What is a reasonable price is a question of fact dependent on the circumstances of each particular case."[23]

Despite the apparent liberality of the Sales Act provision, courts did not supply price terms by construction but rather held contracts unenforceable for indefiniteness, where there was clearly no agreement that a reasonable price was to be paid, or where the contract left price determination to one of the parties.[24] In contrast, the Uniform Commercial Code allows the courts considerably greater leeway in supplying price terms by construction:

(1) The parties if they so intend can conclude a contract for sale even though the price is not settled. In such a case the price is a reasonable price at the time for delivery if:
   (a) nothing is said as to price; or
   (b) the price is left to be agreed by the parties and they fail to agree; or
   (c) the price is to be fixed in terms of some agreed market or other standard as set or recorded by a

third person or agency and it is not so set or recorded.

(2) A price to be fixed by the seller or by the buyer means a price for him to fix in good faith.

(3) When a price left to be fixed otherwise than by agreement of the parties fails to be fixed through the fault of one party, the other may at his option treat the contract as cancelled or himself fix a reasonable price.

(4) Where, however, the parties intend not to be bound unless the price be fixed or agreed and it is not fixed or agreed, there is no contract.[25]

The Code's treatment of contracts without price terms is one of several sections of the Code which implement its general mandate to the courts that, "Even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy."[26] Although the courts have always attempted to honor the intention of the contracting parties in construing written contracts, the Uniform Commercial Code provides clearer guidelines and imposes greater duties in this respect than have ever before existed.

EFFECTS OF PRIOR OR CONTEMPORANEOUS AGREEMENTS

The parol evidence rule is a judge-made rule of law to the effect that:

> When two parties have made a contract and have expressed it in writing to which they have both assented as the complete and accurate integration of that contract, evidence, whether parol [oral] or otherwise, of antecedent understandings and negotiations will not be admitted for the purpose of varying or contradicting the writing.[27]

It is important to realize that the parol evidence rule bars a party to a finalized written contract from enforcing prior written agreements, as well as prior and contemporaneous oral understandings, which are inconsistent with the final written contract.[28] For example, if on May 28 a Farmer initials a purchase order from the ABC canning company providing for delivery of his crop of beans on September 1, and on June 23 signs a formal written contract with respect to the sale of beans which provides for delivery on August 25, in the absence of fraud or mistake, the parol evidence rule will prevent the Farmer from legally relying on the delivery date mentioned in the purchase order. The parol evidence rule does not apply to contemporaneously executed written agreements, which are considered to supplement each other,[29] or to any agreement, oral or written, which is made subsequent to a finalized written contract.[30] Professor Corbin wrote, "Today may control the effect of what happened yesterday; but what happened yesterday cannot change the effect of what happens today. This. . . is the substance of what has been. . . called the 'parol evidence rule'."[31]

There are numerous exceptions to the parol evidence rule. Evidence of prior or contemporaneous understandings, for instance, may be used to show that a written document is not in fact a binding contract because of lack of mutual assent, mistake, fraud, or illegality.[32] Thus, if A writes out a contract for the sale of cattle to B and puts it in his desk drawer, whereupon B somehow gets possession of the document, signs it, and seeks to obtain the cattle from A, no agreement has been reached. A can present the facts by oral testimony, and the written document will not be enforced.[33] Similarly, if A writes, signs, and delivers an offer for the sale of cattle to B, stating orally, "This offer is to be effective only if my sister Hildegard's pies win a blue ribbon at the county fair," B cannot legally accept the offer and enforce the contract unless Hildegard wins the blue ribbon. If B tries to make A deliver the cows despite a poor showing by Hildegard's pies, A can testify concerning the oral condition, and the written document will not be enforced.[34] In the above situations and in numerous others which could be mentioned, the parol evidence rule is no bar to the introduction of written or oral evidence because the purpose of the evidence is to show that a binding contract does not exist, not to contradict the terms of a written document.

The Uniform Sales Act makes no alteration in this traditional conception of the parol evidence rule. On the other hand, the Uniform Commercial Code provides as follows:

"Terms with respect to which the confirmatory memoranda of the parties agree or which are otherwise set forth in a writing

intended by the parties as a final expression of their agreement with respect to such terms as are included therein may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement but may be explained or supplemented

(a) by course of dealing or usage of trade. . . or by course of performance. . .; and

(b) by evidence of consistent additional terms unless the court finds the writing to have been intended also as a complete and exclusive statement of the terms of the agreement."[35]

The Code's unequivocal declaration that a writing which is final in some respects is not to be presumed to be the total agreement of the parties prevents misapplication of the parol evidence rule. Under the Sales Act, courts tend to presume that an apparent complete written contract is in fact complete,[36] so that the parol evidence rule consequently bars oral and written evidence of even prior agreements that are consistent with the written agreement. For instance, suppose a farmer buys a horse that is 7 years old, relying on an oral representation that the horse is 4 years old,[37] but the contract for sale is apparently complete and does not mention the horse's age. Under the Sales Act, it is possible that the parol evidence rule will prevent the farmer from showing that he has agreed to buy a horse that is 4 years old and no older.[38] Under the Code, however, evidence of the oral representation that the horse was 4 years old would be admissible in court, as long as the written contract does not mention the horse's age and there is no clear evidence that the parties intended the writing to be a "complete and exclusive statement" of their agreement.[39]

The Code also modifies the manner in which the parol evidence rule is often applied under the Sales Act. The Code declares that the terms of a finalized written contract can always be "explained or supplemented" by oral evidence of prior dealings between the parties, trade usage, and the manner in which the contract has been performed.[40] In essence, this statement means that oral evidence of the commercial setting of a contract is always admissible under the Code, unless the parties specifically exclude this possibility through explicit contractual provisions. In non-Code States, evidence of the manner in which a contract has been performed is also generally admissible as an aid to interpretation, but the parol evidence rule may be considered to interdict evidence of prior dealings or trade usage, unless an ambiguity is apparent on the face of the contract.[41] However, this difference between Code and Sales-Act jurisdictions is more apparent than real. Some of the surrounding circumstances must be known before it can be determined with confidence whether words are ambiguous or unambiguous.[42] In Frigaliment Importing Co. v. B.N.S. Internat'l Sale Corp.,[43] involving a sale of chickens, for instance, the court admitted parol evidence to determine whether the parties used "chickens" to refer to broilers and fryers or to stewing chickens, or to all three.

Under both the Code and the Sales Act, the parties can draft a written contract so as to take maximum advantage of the parol evidence rule, if they so desire. The arrangement can be accomplished in part through a "merger" clause which may, for instance, provide that "this contract contains the entire agreement between the parties. There is no oral understanding, or representation, or agreement relative to this contract which is not fully expressed herein." Each party should be aware that, by agreeing to a written vertical coordination contract containing a merger clause, he ordinarily precludes himself from enforcing against the other party any prior or contemporaneous understandings that do not appear in the writing.[44] Appropriate contract provisions may limit the admission of parol evidence for purposes of interpretation. A contract may include definitions of its important terms and specifically or generally negate the pertinency of trade customs.[45] However, because of the parol evidence rule, the more complete a writing becomes, the more careful the parties should be to make sure that it expresses their true intent.

SUBSEQUENT MODIFICATION OF A WRITTEN CONTRACT

The principal legal hurdles that must be surmounted in an agreement to modify or to abandon a written contract are the doctrine of consideration and the statute of frauds.[46]

Consideration, which is ordinarily necessary to make any promise enforceable, may be defined as something bargained for and given in exchange for a promise.[47] In many instances, consideration will consist

of a return promise. Thus, if A promises to sell 160 bushels of wheat to B, provided that B promises to pay cash for the wheat on delivery, and B so promises, each promise is consideration for the other.

In States that have not enacted the Uniform Commercial Code, consideration is usually required to render the abandonment or modification of a contract enforceable.[48] If the parties to a contract mutually agree to abandon the contract, consideration is present in the reciprocal promises to release each other from the contract obligation.[49] On the other hand, consideration is not necessarily present when an attempt is made to modify an existing contract. Assume that a Contractor agrees to buy 200 hogs at a certain price from a Farmer; then, because of an epidemic of hog cholera, hogs become scarce and the market price for immediate delivery rises. The Farmer informs the Contractor of this fact and demands that the Contractor agree to pay $5 more per hundredweight in order to receive delivery on the contract date. The Contractor reluctantly agrees but on receipt of the hogs tenders only the original purchase price. If the Farmer goes to court in an attempt to recover the extra payment promised by the Contractor, he will lose. The Contractor's promise to pay the extra amount is not supported by legally sufficient consideration and is consequently unenforceable.[50] The Contractor received no consideration for his promise to pay extra compensation, since the Farmer was under a preexisting contractual duty to deliver the 200 hogs on the date specified in the contract. However, if the Farmer had assumed a new contractual duty in exchange for the Contractor's promise to pay the extra $5 per hundredweight (if, for example, the Farmer had agreed to delivery the hogs 2 weeks prior to the original delivery date), the Contractor would have received something in exchange for his new promise, and the revised contract would have been enforceable.

The Uniform Commercial Code sweeps away the requirement that abandonment or modification of a sales contract be supported by consideration in order to be binding.[51] However, the Code's general prerequisite that, "Every contract or duty within this act imposes an obligation of good faith in its performance or enforcement,"[52] is intended to fulfill the function of the doctrine of consideration in a more flexible manner. "Good faith" means honesty in fact with respect to a nonmerchant[53] and observance of reasonable standards of commercial fair dealing with respect to merchants.[54] The good faith requirement permits the parties to adjust their contracts for legitimate commercial reasons[55] --where, for example, performance of a contract would cause unforeseen difficulty, expense, or hardship[56] --but the Farmer mentioned above would fare no better under the Code than he did under the Sales Act. It is neither honesty in fact nor commercial fair dealing to attempt to extract a contract modification simply because of a desire to make a greater profit.[57]

The statute of frauds is a separate barrier to abandonment and modification of written contracts in both Code and non-Code States, and sometimes the parties attempt to write a private statute of frauds into the contract itself. Examples of these provisions include (1) "No statement or promise covering the broilers mentioned in this contract shall modify or terminate this contract unless the statement is in writing and signed by both parties"; (2) "variations of this contract must be in writing and signed by the parties hereto"; and (3) "a change of this contract is not valid unless signed by an authorized agent of the Contractor." Despite an obvious manifestation of an intent to preclude subsequent oral modification of a contract, the parties in non-Code States cannot rely on clauses requiring written modification to protect them from liability, if they in fact agree to a subsequent oral modification. The courts have generally disregarded written modification clauses in these circumstances, reasoning that the parties are free to abandon orally the provision requiring written modification and then to proceed to modify orally the rest of the contract.[58] The Uniform Commercial Code, however, adopts a contrary position:

"A signed agreement which excludes modification or rescission [abandonment] except by a signed writing cannot be otherwise modified or rescinded [abandoned], but except as between merchants such a requirement on a form supplied by the merchant must be separately signed by the other party."[59]

Except where this provision of the Code applies, the parties to a contract can almost always orally agree to abandon a written contract. Consideration, if necessary, is present in the mutual promises to forbear enforcement, and the statute of frauds has no application to oral abandonment of a contract for a sale of goods that has not

been performed.[60] However, if ownership of the goods has passed, the abandonment of the contract for sale amounts to a resale of the goods to the original seller, and the oral agreement for abandonment will be unenforceable if the price or value of the goods makes the statute of frauds applicable. In this event, the original contract for sale will be considered still in effect, unless and until the agreement for abandonment becomes enforceable through satisfaction of the statute of frauds.[61] This analysis also applies to oral contract modifications that fall within the statute of frauds. If an oral modification does not become enforceable through satisfaction of the statute, the original contract remains in effect.[62] Thus, if A originally agrees in writing to sell B 100 milk cows for $10,000, deliverable on July 15, but the parties later orally change the delivery date to August 25, the oral modification will be unenforceable due to lack of consideration in a non-Code State and due to noncompliance with the statute of frauds in both Code and non-Code States; the original contract will remain in force.

As has been pointed out, the doctrine of consideration and the doctrine of good faith established by the Uniform Commercial Code ordinarily present greater problems with respect to modification than with respect to abandonment of a contract. Where one of these legal principles invalidates a modification that at least one of the parties believed was enforceable, considerable hardship can result. To compensate for this, the courts have formulated at common law,[63] and legislatures have enacted in the Uniform Commercial Code,[64] a doctrine of waiver. The doctrine may be stated as follows: The words or conduct of a contracting party concerning an unenforceable modification of a contract will result in waiver of conditions of the other party's performance, if the latter reasonably relies on those words or that conduct in performance of his contractual duty. Thus, because the previously mentioned oral postponement of the delivery date for the 100 milk cows was unenforceable, B does not have to keep his promise to accept delivery on August 25; but, because B invited A to ignore the delivery date specified in the written contract, B waived A's obligation to deliver the cows before August 25, unless he give A ample notice that he has changed his mind. B will not be allowed to sue A for failure to deliver prior to August 25 if B remains silent subsequent to the oral modification. The law does not require that A be able to read B's mind.

FOOTNOTES--CHAPTER 3

[1] See Comment, A New Departure in the Statute of Frauds 70 Yale L.J. 603, 608 (1961).

[2] Uniform Sales Act § 71 [hereinafter cited as U.S.A.].

[3] Uniform Commercial Code § 1-203 [hereinafter cited as U.C.C.].

[4] Kinyon & McClure, A Study of the Effect of the Uniform Commercial Code on Minnesota Law § 1-203, Comment Discussion (1964).

[5] 3 Corbin, Contracts § 546 [hereinafter cited as Corbin].

[6] Cain v. Hunter, 161 Cal. App. 2d 808,327 P.2b 583 (1958).

[7] Ibid.

[8] 3 Corbin § 448.

[9] U.C.C. §§ 1-205(1), 2-208(1).

[10] U.C.C. § 2-208, Comment 1.

[11] 3 Corbin § 555.

[12] Franklin Sugar Refining Co. v. Lipowicz, 247 N.Y. 465, 169 N.E. 916 (1928).

[13] Parks v. O'Connor, 70 Tex. 377, 8 S.W. 104 (1888).

[14] Floyd v. Mann, 146 Mich. 356, 109 N.W. 679 (1906).

[15] U.C.C. § 1-205(2).

[16] U.C.C. § 1-205(5), Comment 4.

[17] 3 Corbin § 556.

[18] Robinson v. United States, 30 U.S. (13 Wall) 363 (1871).

[19] U.C.C. § 1-205(5), Comment 4.

[20] U.C.C. § 2-208(2).

[21] 1 Corbin § 95, at 400.

[22] E.g., A.M. Webb & Co. v. Robert P. Miller, Co., 176 F.2d 678 (3d Cir. 1949).

[23] U.S.A. § 9(1) & (4).

[24] 1 Corbin §§ 97, 98.

[25] U.C.C. § 2-305.

[26] U.C.C. § 2-204(3). See also U.C.C. § 2-306 (agreements relating to total output, requirements, and exclusive dealings); U.C.C. § 2-311 (agreements which leave details of performance to be specified by one of the parties).

[27] 3 Corbin § 573, at 357.

[28] Id. § 576.

[29] Restatement, Contracts § 237, Comment a (1932).

[30] 3 Corbin § 574.

[31] Id. § 574, at 372.

[32] Id. §§ 577, 580.

[33] Id. § 580, at 438.

[34] Id. § 592.

[35]U.C.C. § 2-202.

[36]E.g., Seitz v. Brewers' Refrigerating Mach. Co., 141 U.S. 510, 511, 517 (1891); 4 Williston, Contracts § 633 (3d ed. 1961) [hereinafter cited as Williston].

[37]See chapter 5 infra with respect to warranties by representation.

[38]Cf. Bush v. Bradford, 15 Ala. 317 (1849).

[39]U.C.C. § 2-202.

[40]Ibid.

[41]3 Corbin §§ 558, 579.

[42]Id. § 542.

[43]190 F. Supp. 116 (S.D.N.Y. 1960).

[44]Note, "Contract Draftsmanship Under Article 2 of the Uniform Commercial Code", 112 U. Pa. L. Rev. 564, 566-67 (1964).

[45]Comment, "An Anatomy of Sections 2-201 and 2-202 of the Uniform Commercial Code", 4 B.C. Indus. & Comm. L. Rev. 381, 395 (1963).

[46]3 Corbin § 574.

[47]Restatement, Contracts § 75 (1932).

[48]Id. §§ 406, 417, Comment c.

[49]Id. § 406, Comment a.

[50]1A Corbin § 175.

[51]U.C.C. § 2-209(1).

[52]U.C.C. § 1-203.

[53]U.C.C. § 1-201(19).

[54]U.C.C. § 2-103(1)(b). "Merchant" is defined in U.C.C. § 2-104(1).

[55]U.C.C. § 2-209, Comment 2.

[56]1A Corbin § 184.

[57]Id. § 183.

[58]6 Corbin § 1295.

[59]U.C.C. § 2-209(2).

[60]2 Corbin § 302.

[61]Cf. 2 Corbin § 312.

[62]Ibid.

[63]2 Corbin § 310.

[64]U.C.C. § 2-209(4) and (5).

CHAPTER 4. RELATIONSHIPS AND RESPONSIBILITIES

This chapter sketches some of the consequences of the principal legal relationships created by vertical coordination contracts; namely, partnership, joint venture, agency, employment, and independent contractor. Discussion is focused on the distinctions between these relationships.

PARTNERSHIP AND JOINT VENTURE

Partnership has been defined as an association of two or more persons as co-owners of a business for profit.[1] The most important single factor in determining whether a partnership relationship exists is the disposition of profits and losses arising from the transactions of the parties.[2] If profits and losses are to be shared, there is probably a partnership.[3] However, the sharing of profits and losses does not conclusively show that the persons so sharing are partners.[4] For example, a landlord's rent may be based partially or wholly upon a tenant's profits, and a creditor may agree that a debt can be repaid exclusively from the debtor's profits. Although both the landlord and the creditor would share in profits, they would not be partners of the tenant or the debtor.

In many of the vertical coordination contracts studied, the price to be paid to a Farmer bore no relationship to the profits of either the Contractor or the Farmer; and a partnership relationship accordingly was not involved. The participants in vertical coordination contracts were usually not partners, even where the price to be received by a Farmer was based on a percentage of the Contractor's profits, because the parties seldom agreed to share losses. This does not mean, however, that the parties must explicitly agree to share the profits and losses in order to be considered partners. Where an agreement to share profits exists, a court can infer that losses are also to be shared.[5] In the clear cases of the landlord and the creditor, referred to above, no inference should be drawn that these persons intended to share either losses or profits,[6] and these persons would not, therefore, be partners. However, if a vertical coordination contract provides that the parties shall share profits, and directly or indirectly allocates losses between the parties, the relationship between the Farmer and the Contractor could conceivably be a partnership.

Another characteristic of a partnership is mutual management and control.[7] A distinction must be made between allocation to the respective parties of selected aspects of management responsibility and participation in mutual or joint management and control. Many of the vertical coordination contracts provided for some division of management responsibility, but this normally involved a transfer of full authority in certain aspects of the endeavor to one of the parties and was not the type of joint control that typifies a partnership. Other indications of partnership are co-ownership of business property and mutual contribution of property, labor, or skill to the business undertaking.[8] The fact that two persons do business under a partnership name, or represent to others that they are operating as a partnership, will also tend to show that a partnership actually exists.[9]

In an ambiguous situation, a determination as to the existence of a partnership must be based on evaluation of all relevant circumstances. The final determination, however, involves consideration of all factors discussed above.

A "joint venture" is similar to a partnership. The principal difference is that a joint venture is usually formed for a single specific undertaking, like the raising of a single crop, and is, therefore, more limited in scope and duration than a partnership.[10] Otherwise, the tests for the existence of a joint venture and a partnership are the same.[11]

1) Agency is the fiduciary [confidential] relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.
2) The one for whom action is to be taken is the principal.
3) The one who is to act is the agent.[12]

The employer-employee, or master-servant, relationship is a type of agency in which the employer is a principal and the employee is an agent.[13] The employer-employee relationship is distinguished from other agencies by the limited discretion available to an employee. An employer has a right to control the details of an employee's performance of his authorized duties, whereas other principals do not have this right.

Nonemployee-agents are not subject to direct and detailed control by their principals in rendering contract services. They are a species of independent contractors, persons who undertake to perform services without subjecting themselves to supervision in that performance.[14]

Independent-contractor agents should be sharply distinguished from both employee-agents and independent contractors who are not agents. Anyone who agrees to perform unsupervised services for another is an independent contractor, whereas an independent-contractor agent also agrees to act on behalf of his principal in the performance of the services.[15]

Some of the vertical coordination contracts gave the Contractor a degree of supervisory power over the Farmer. If this supervisory power was coupled with an authorization for the Farmer to represent the Contractor in certain respects, a question arises whether the Farmer would be an independent-contractor agent or an employee. If there was no accompanying authorization to act on behalf of the Contractor, the question is whether the Farmer would be an independent contractor or an employee. In either situation, the relevant questions are as follows: To what extent does the agreement entitle the Contractor to exercise control over the details of the Farmer's performance? Is the Contractor engaged in a different business from the Farmer? Does the contract relate to a type of performance in which the employer-employee relationship is customary? What skill is required to perform the contract services? Is the work which the Farmer contracts to perform a regular part of the business of the contracting firm? What is the duration of the contract? What is the method of payment, whether by time consumed or by the job? Does the Contractor or the Farmer supply the tools, instruments, and place where the contract work is to be performed? Do the parties believe that they have created an employer-employee, independent contractor, or some other relationship? Is the Contractor regularly engaged in business?[16]

The most important factor in gauging the existence of an employer-employee relationship is the degree of control that can be exercised over the person asserted to be an employee by the person asserted to be an employer.[17] The amount of control to be exercised over the Farmer in the contracts studied varied considerably. For example, a Farmer's freedom of action was generally more restricted by canner-grower contracts than by livestock feeding contracts. The Contractor's reasons for entering the arrangement accounted for the difference in degree of control. A canner's purpose in making a vertical coordination contract is primarily to guarantee a source of raw materials of a certain kind, quality, and quantity, for delivery on a particular date at a specified place and price. On the other hand, in the livestock feeding industry, the Contractor is sometimes a company manufacturing, or "jobbing," feed, and its principal purpose is to sell more feed. The Contractor usually supplies the Farmer with feed (and perhaps with some other inputs) and may finance the entire operation. In some instances, the Contractor promises to purchase the livestock raised by the Farmer, or the Contractor may only promise to try to find a purchaser.

If a Contractor furnishes the seed for producing a commodity, selects the insecticide and fertilizer to be used, supervises and selects the time and method of planting, determines the harvest date, specifies the date of delivery, and supplies necessary equipment and additional specialized labor, the relationship between the Contractor and the Farmer may be tantamount to that of employer-employee. In the typical vertical coordination contract studied, there was not, however, sufficient control exercised to conclude that the Farmer was an employee of the Contractor. Instead, the control factor indicated that the Farmer was an

independent contractor under most of the vertical coordination contracts studied.

Indeed, according to most of the other criteria for identifying an employer-employee relationship, the typical vertical coordination contract failed to create such a relationship. In the contracts studied, the Farmer was almost always engaged in a business which was separate and independent from that of the Contractor. Also, most vertical coordination contracts covered only one of the several farm production enterprises in which the Farmer was engaged. Similarly, the Farmer's performance of the contract was rarely a type of activity in which the employer-employee relationship is customarily established. In the vertical coordination contracts, the Farmer was ordinarily called upon to perform a complex job entailing considerable skill and management, quite unlike the services of typical farm laborers, although not dissimilar to the service performed by a hired farm manager.

The Farmer typically agreed to supply a considerable amount, if not all, of the land, tools, and other inputs necessary for his performance of the contract. Payment was usually due when the Farmer completed performance of the contract. The parties to a vertical coordination contract seldom expressly defined their relationship in the contract, but where they did, they were more likely to refer to an independent contractor than to an employer-employee relationship. The duration of an average vertical coordination contract was not significant, since it was usually geared to the relevant crop year or production period for livestock because of the nature of the contract goods (rather than because of the nature of the relationship between Farmer and Contractor).

Finally, the fact that a Contractor usually was regularly engaged in business has little importance because the farmers with whom he contracts are generally engaged in a different business. On balance, therefore, typically an independent contractor relationship--not an employer-employee relationship--exists between the parties to a vertical coordination contract.

SIGNIFICANCE OF THE VARIOUS RELATIONSHIPS

The type of relationship created by a vertical coordination contract determines the rights and responsibilities of the parties with respect to each other. If an agency relationship is created, for example, the agent has a fiduciary duty to act on behalf of his principal, including the following:

"The duty to account for profits arising out of his employment, the duty not to act as, or on account of, an adverse party without the principal's consent, the duty not to compete with the principal on his own account or for another in matters relating to the subject matter of the agency, and the duty to deal fairly with the principal in all transactions between them."[18]

Similar duties exist between partners and joint venturers, since both relationships are closely related to an agency relationship.[19] On the other hand, if the parties are mere independent contractors, they owe no duties to each other beyond those imposed by the terms of their contract. Thus, a farmer-agent would have a duty imposed by law to disclose defects in contract goods to the contractor, whereas a farmer-independent contractor would only be liable to the contractor for defects in the contract goods that resulted in a breach of warranty.

The relationship established by a vertical coordination contract also has an important bearing on the rights and responsibilities of the parties with respect to third persons. If the relationship between a Farmer and a Contractor is that of partnership, joint venture, or agency, the Farmer can usually enter into contracts with third persons that will bind the Contractor.[20] On the other hand, independent contractors who are not agents cannot make contracts with third persons on behalf of the persons with whom they have contracted. It is important to remember, however, that independent contractors may also be agents.[21] Merely to determine that a Farmer is an independent contractor and not a partner does not, therefore, preclude the possibility that he can obligate a Contractor to a third person. The basic factor which determines whether one can bind another contractually is the existence of authority to do so.[22] Agents, partners, and joint venturers almost always have this authority. Independent contractors and employees may or may not have it. Thus, a particular Farmer may be correctly termed an independent contractor, because the Contractor to whom he has contracted to sell his beef cattle does not have the right to control his day-to-day

operations. Nevertheless, if the contract provides that the Contractor will pay for the feed, the Farmer may be considered to have implied authority to buy feed in the Contractor's name and may be the Contractor's agent to that extent.

The authority necessary to enable a Farmer to contract on behalf of a Contractor need not be expressly conferred by the Contractor. If the Contractor has acted in such a way as to lead other people to think that the Farmer has the authority to bind him, the Farmer may be deemed to have "apparent authority" to do so.[23] If the Contractor without objection pays for feed purchased by the Farmer, the feed seller will be justified in believing that the Farmer has the authority to bind the Contractor, and the Farmer will have apparent authority to do so in the future.

The relationship between the parties is also important if a third person suffers loss in the course of the Farmer's performance of the contract; for example, by improper use of an insecticide. If the relationship is partnership, joint venture, or agency, the Contractor as well as the Farmer may be liable for the injuries.[24] If the relationship is that of independent contractors, the Contractor will not ordinarily be liable.[25]

Finally, the legal relationship between a Farmer and a Contractor may affect the applicability of Federal and State laws to the parties. Thus, in the exceptional case in which a Farmer can be considered an employee of the Contractor, the Farmer may be entitled to collect workmen's compensation if he is injured in the performance of the contract.[26]

As established in this chapter, the type of legal relationship created in a vertical coordination contract is of considerable importance to both parties, for their rights and responsibilities are materially affected by this relationship. Each party, therefore, should be careful that the desired relationship is established and that any subsequent action does not lead a third party to believe otherwise.

FOOTNOTES--CHAPTER 4

[1] Uniform Partnership Act § 6; Restatement (Second), Agency § 14A (1958).

[2] Mecham, Partnership §§ 75-77 (1920).

[3] Ibid.

[4] Ibid; Uniform Partnership Act § 7(4).

[5] Mecham, Partnership §§ 78-79 (1920).

[6] Uniform Partnership Act § 7(4).

[7] Mecham, Partnership § 177 (1920).

[8] Id. § 2.

[9] Id. § 65.

[10] Mecham, Partnership §§ 14, 43 (1920).

[11] Id. §§ 17, 21.

[12] Restatement (Second), Agency § 1 (1958).

[13] Id. §§ 2(1) and (2).

[14] Id. § 2(3) and Comment b (1958).

[15] Ibid.

[16] See Id. § 220.

[17] Id. § 2.

[18] Id. § 13, Comment a.

[19] Seavy, Agency § 10A (1964) (partnership); 2 Williston, Contracts § 318C (3d ed. 1959) (joint venture).

[20] Uniform Partnership Act §§ 13-15; Restatement (Second), Agency § 144 (1958).

[21] Restatement (Second), Agency § 220, Comment e (1958).

[22] Mecham, Agency § 14 (1952).

[23] Restatement (Second), Agency § 8 (1958).

[24] Uniform Partnership Act § 13; Restatement (Second), Agency §§ 215, 216, 219(1958).

[25] Prosser, Torts § 70 (3d ed. 1964).

[26] Marcus v. Agricultural Ass'n, Inc., 32 N.J. 460, 161 A.2d 247 (1960), reversing per curiam, 58 N.J. Super. 584, 157 A.2d 3 (App. Div. 1959).

CHAPTER 5. WARRANTIES

In the law of sales, the term "warranty" refers to an obligation of a seller to a buyer with respect to the nature of the goods that are the subject of the contract for sale.[1] If this obligation is breached, the law affords the buyer remedies, including money damages and an opportunity to renounce his obligations under the contract.[2] Warranties have a dual significance for farmers involved in vertical coordination contracts. Insofar as these contracts obligate farmers to purchase goods, warranties can constitute an added protection. Insofar as these contracts obligate farmers to sell goods, warranties can constitute an added responsibility.

A warranty obligation may be voluntarily assumed under a vertical coordination contract, as where a Farmer tells a prospective Contractor that the crop offered for sale is unmortgaged, or the obligation may be imposed by law, as where the Uniform Commercial Code declares that a Farmer is presumed to warrant that he has good title to the crop or livestock that he contracted to sell.[3] As the first example indicates, voluntary warranties may be oral as well as written. However, if an oral contract to sell is eventually reduced to writing, prior oral representations or promises may not be considered warranties unless they are referred to in the writing. This situation does not occur with regard to imposed warranties, which are presumed to exist whether a contract is oral or written, unless the parties indicate a contrary intent.[4]

The distinction between voluntary and imposed warranties is substantially equivalent to the traditional differentiation between express and implied warranties found in the Uniform Sales Act. The Sales Act defines an express warranty as follows:

> Any affirmation of fact or any promise by the seller relating to the goods. . . .if the natural tendency of such affirmation or promise is to induce the buyer to purchase the goods, and if the buyer purchases the goods relying thereon.[5]

The implied warranties recognized by the Sales Act are legally presumed to exist, unless the parties to a sales transaction indicate a contrary intent.[6] The Sales Act provides the same legal remedies for breach of both express and implied warranties,[7] but whether a warranty is express or implied is an important factor in determining if the warranty exists in a particular case and in determining if the warranty has been disclaimed or modified. Express warranties that would otherwise exist generally must be specifically disclaimed or limited, whereas implied warranties can be negated or altered by implication.[8] Treatment of warranties by the Uniform Commercial Code differs from that of the Uniform Sales Act in several respects. Certain important imposed warranties are treated as express warranties for the purpose of disclaimer or modification, and specific statutory provisions dealing with disclaimer and modification have been added.

EXPRESS WARRANTIES

The Uniform Commercial Code explicitly recognizes three types of express warranties: An affirmation of fact or a promise made by a seller to a buyer regarding the goods that are the subject of a contract for sale, a description of those goods by the seller to the buyer, or a sample of those goods shown by the seller to the buyer.[9] The Code also treats the imposed warranties of title in the seller, rightful transfer, and freedom from security interests as though they were express warranties.[10] In this respect, the Code differs from the Uniform Sales Act, which considers all warranties, except those arising from a representation or a promise by the seller, to be implied warranties.

No particular language is required to give rise to an express warranty of representation or promise. Any representation or promise which goes to the essence of a particular bargain will be treated as an

express warranty, however inartfully phrased.[11] It is, likewise, immaterial that a seller does not intend that his statement of fact or promise constitute a warranty, or that a seller is under an honest, but mistaken, impression that his statement is true. An express warranty of representation or promise protects the buyer, who reasonably relies upon it regardless of the seller's good faith or loose talk.[12] This is not to say that every statement by a seller concerning goods will constitute an express warranty of representation or promise. The Uniform Commercial Code specifically provides that ". . . an affirmation merely of the value of the goods or a statement purporting to be merely the seller's opinion or commendation of the goods does not create a warranty."[13] The test to determine whether a seller's statement is a mere matter of opinion or a warranty is to ascertain if the statement is important enough to the buyer to become ". . . part of the basis of the bargain. . . ."[14] Under both the Sales Act and the Code, an important consideration is whether the seller possesses, or purports to possess, superior information concerning the subject of his comments.[15] It was held to be a warranty and not a statement of opinion, for instance, where a salesman of a weed killer assured a doubtful farmer that the weed killer would not produce a toxic condition in the soil that would injure the farmer's crops.[16] If there is doubt whether a particular comment is a warranty or a statement of opinion, the Official Comments to the Code suggest that all statements of a seller should be considered express warranties ". . . unless good reason is shown to the contrary."[17]

Under the Uniform Commercial Code, contracts for sale containing a description of the goods and contracts for sale made on the basis of the buyer's examination of a sample of the goods involve express warranties.[18] Thus, if Jones writes to Smith offering to buy a black stallion and Smith accepts the offer, Smith expressly warrants that the horse delivered will be a black stallion. Delivery of a black mare will not satisfy the express warranty by description of the goods to be sold. Similarly, if a Farmer agrees under a vertical coordination contract to grow X variety of hybrid seed corn to be provided by the Contractor, the contracting seed company has expressly warranted that the seed furnished will be of that variety and not of Y variety. In contrast to the Code, the Uniform Sales Act treats contracts for sale made on the basis of a description of the goods, or an examination of a sample of the goods, as raising implied warranties.[19]

The Uniform Commercial Code specifies that every contract to sell includes, by operation of law, ". . . a warranty by the seller that (a) the title conveyed shall be good, and its transfer rightful; and (b) the goods shall be delivered free from any security interest or other lien or encumbrance of which the buyer at the time of contracting has no knowledge."[20] This provision, in effect, creates an express warranty of title, although it is not explicitly so designated by the Code. The warranty of title is an implied warranty under the Sales Act.[21]

In some vertical coordination contracts studied, the Contractor required that the Farmer give voluntary warranties by representation or promise concerning matters that were also the subject of imposed warranties of title, description, or sample. In jurisdictions where the Uniform Sales Act is in force, this additional requirement removes any argument that these implied warranties have been negated by the circumstances. Even where the Uniform Commercial Code has been enacted, an express warranty by representation, or promise, which overlaps a statutory express warranty removes any doubt as to the scope of the express warranty and is evidence of reliance on the warranty by the Contractor.[22] Indeed, the usefulness of an express warranty by representation or promise, despite a similar statutory warranty, extends beyond considerations of warranty law. Assume, for example, that a rascally Farmer contracts to sell the same carrots to two different Contractors and that the particular variety of carrots is not readily obtainable elsewhere. The Contractors can, of course, recover damages from the Farmer to the extent that he (the Farmer) fails to perform his contracts, but in this situation both Contractors would probably prefer delivery of the scarce carrots. If a judge were convinced that the second Contractor was unaware of the first contract when he dealt with the Farmer, the judge could order that half of the crop be delivered to each of the Contractors and award damages for the unfulfilled portion of both contracts.[23] An express warranty by representation in the second contract, to the effect that the Farmer had not previously contracted to sell the carrots to another person, would duplicate the statutory warranty of rightful transfer, but it also might help to convince the judge of the second Contractor's good faith.

IMPLIED WARRANTIES

Both the Uniform Commercial Code and the Uniform Sales Act recognize certain implied warranties of quality; namely, an implied warranty of merchantability and an implied warranty of fitness for a particular purpose.[24] The Code's implied warranty of merchantability is considerably broader than that of the Sales Act, since the latter confines the implied warranty to sales by description and omits a definition of merchantability. Insofar as vertical coordination contracts are concerned, the implied warranty of fitness for a particular purpose is roughly the same under both Acts.

The Code implies a warranty of merchantability in all contracts in which the seller is a "merchant," defined as ". . . a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction. . . ."[25] A Farmer who contracts to sell the products of his farm probably qualifies as a merchant on both counts, as, of course, do many Contractors with whom Farmers deal.[26] In order to satisfy the implied warranty of merchantability, goods must at least be such as:

(a) pass without objection in the trade under the contract description; and
(b) in the case of fungible goods, are of fair average quality within the description; and
(c) are fit for the ordinary purposes for which such goods are used; and
(d) run, within the variations permitted by the agreement, of even kind, quality, and quantity within each unit and among all units involved; and
(e) are adequately contained, packaged, and labeled as the agreement may require; and
(f) conform to the promises or affirmations of fact made on the container or label if any.[27]

The implied warranty of fitness for a particular purpose arises where a seller has reason to know at the time of contracting that a buyer plans to use the goods for a particular purpose and relies on the seller to select or furnish suitable goods.[28] For example, if a seller knows that a farmer wishes to buy feeder cattle, the contract to sell will contain an implied warranty that the cattle delivered will be healthy and capable of putting on weight.[29]

A contract to sell may contain both of the implied warranties of quality--merchantability and fitness for a particular purpose--if the seller qualifies as a merchant and knows both of the buyer's special purpose for the goods and the buyer's reliance on the seller's selection of suitable goods. A contractor who regularly sold hogs, for instance, could be chargeable with both implied warranties where he knew that the purchaser wanted a boar for breeding purposes.[30] In this situation, it would be possible for one of the implied warranties to be breached but not the other. The boar might be merchantable because he is in general good health and fit for slaughter, but nonetheless unfit for the particular purpose of breeding due to sterility.

DISCLAIMER OF WARRANTIES

Contract clauses denying the existence of warranties were common in the vertical coordination contracts studied. Such a clause may read: "Contractor gives no warranty, express or implied, as to the description, quality, or productiveness of seed furnished and is in no way responsible for the crop." The effectiveness of a disclaimer often varies, depending on whether an express or an implied warranty is involved.

If no express warranties have been made by the seller, whether he is the Contractor or the Farmer, it would seem unnecessary to say so in the contract. This redundancy may, however, be of practical value to the seller. First, it may help convince a judge that the parties intended the writing to be an "integration" of their entire contractual agreement, in which case evidence of prior express warranties would be inadmissible in court.[31] On the other hand, if the seller does make some express warranties in the written contract itself, the disclaimer clause will not deprive them of legal effect. Where a seller actually makes express warranties that become the basis for a bargain, these warranties will be enforced despite the inclusion of a general disclaimer clause in the contract. The Uniform Commercial Code provides that, if a contract contains express warranties, as well as language tending to limit or negate the warranty obligation, the limiting language is inoperative to the extent that it is inconsistant with

the express warranties.[32] Although the Uniform Sales Act has no provision directly in point, the results of the cases decided under the Sales Act are in substantial accord with the Code provision.[33] The statutory warranty of title imposed by the Code can be avoided, but ". . . only by specific language or by circumstances which give the buyer reason to know that the person selling does not claim title in himself or that he is purporting to sell only such right or title as he or a third person may have."[34]

The implied warranties of quality imposed on a seller pertain to the merchantable quality of the goods or to their fitness for a particular purpose. The Uniform Commercial Code provides, ". . . to exclude or modify the implied warranty of merchantability or any part of it the language must mention merchantability and in case of writing must be conspicuous, and to exclude or modify any implied warranty of fitness the exclusion must be by a writing and conspicuous."[35] The Official Comments further emphasize that a disclaimer of the implied warranty of merchantability must specifically and directly refer to the merchantability of the goods sold. The implied warranty of fitness for a particular purpose, on the other hand, can be disclaimed in more general terms. As the Code states, "Language to exclude all implied warranties of fitness is sufficient if it states, for example, that 'There are no warranties which extend beyond the description on the face hereof.' "[36] A disclaimer of the implied warranty of fitness for a particular purpose must be in writing, even if the rest of the contract is oral, and it must be a conspicuous part of the writing if the contract is written.[37] A disclaimer of the implied warranty of merchantability need not be in writing if the contract is oral, but if the contract is written, the disclaimer must be a conspicuous part of the written contract.[38] The Code tempers its initially harsh treatment of disclaimers of implied warranties of quality with several exceptions. Implied warranties of quality can be effectively negated by "language which in common understanding calls the buyer's attention to the exclusion of warranties and makes plain that there is no implied warranty. . . ." with respect to defects discoverable during the buyer's examination of the goods or in cases where the buyer refuses to examine the goods, or where there exists an inconsistent course of dealing, performance, or trade usage.[39]

The Uniform Sales Act contains no express language dealing with the exclusion or modification of implied warranties by disclaimer clauses. The cases decided under the Sales Act, however, are in substantial accord with the treatment of this subject in the Uniform Commercial Code.[40] The judicial treatment of disclaimer clauses has, in general, been very strict. When a buyer sues a seller for breach of an implied warranty under a sales contract containing a general disclaimer of warranties clause, the courts have usually gone to extreme lengths to "interpret" the clause so that it will not bar the buyer's recovery of damages. Although the courts often say that the parties to a contract may exclude any warranties that they do not wish to be applicable, the actual results of the cases seldom support this statement. For example, a clause excluding "all warranties" has been held to mean only express warranties and not implied warranties, and a clause excluding "all warranties, whether express or implied" has been interpreted to mean only express and implied-in-fact warranties (tacit representations arising from the conduct of the parties) and not to apply to the implied warranties imposed by statute, like the warranty of merchantability. In a few instances, legislatures have also come to the aid of buyers and passed statutes making a disclaimer of certain warranty obligations illegal and void.[41]

Although courts are usually reluctant to allow a seller to avoid the implied warranties specifically imposed by the Uniform Commercial Code and Uniform Sales Act, sometimes a seller may successfully disclaim these warranties. At least three factors appear to influence the courts in deciding whether a particular implied warranty has been effectively disclaimed. The first factor is the relationship between the price of the goods sold under the contract and the amount of damages likely to be caused by the breach of an implied warranty. If the price of the goods is small in relation to the potential amount of damage, the courts will be more inclined to give effect to a disclaimer clause. The sale of seed to a Farmer is a good example. The price of the seed will ordinarily be relatively small in comparison with the amount of damages that the Farmer will suffer if the seed does not grow, or if it turns out to be of a different type than that ordered. The Farmer's damages, for instance, could be the profit which the mature crop would have brought if the seed had been of the type

ordered and of merchantable quality.[42] The great financial liability that could result from making the seed company liable for such damages on each sale of seed has undoubtedly been a factor which has influenced the courts to give effect to a disclaimer clause in these situations.

Another significant factor is the difficulty in determining whether seed will grow or whether it is of the variety ordered. For example, a seed company under a vertical coordination contract must make reasonable efforts to ascertain the type and quality of seed it sells. If it does not do so, or if it attempts to defraud or mislead the buyer, the company will be liable for the resulting damages on a theory of negligence, or fraud, wholly apart from any question of warranty. However, where the company has done all that can be reasonably expected in an attempt to supply its buyers with good quality seed of the type ordered, the courts tend to give effect to a clause disclaiming implied warranties as to merchantability and fitness for a particular purpose.[43]

A third factor which seems to influence the courts to honor disclaimer clauses is the explicitness of the clause and the likelihood that the buyer had notice of its existence and understood its intended effect. Even though the first two factors mentioned are favorable in a given case, a court will generally not enforce a clause disclaiming an implied warranty unless it would be fair to do so. The fairness often depends on whether the disclaimer provision is clear and unambiguous and whether the buyer fully comprehended its purpose. It is common in many businesses for sellers to insert standardized disclaimer provisions in contracts of sale. This is, for instance, the case in the seed business. A buyer of seed will, therefore, usually be acquainted with this type of provision and indeed may expect to see it in the contract. Where a buyer was fully cognizant of the presence and purpose of a disclaimer clause, a court may understandably determine that the buyer should be held to his bargain.[44]

In summary, if it is difficult for the seller to determine in advance the type or quality of goods sold, and if the price received for the goods is small in relation to the damages that may be caused if the goods turn out to be the wrong type or nonmerchantable, the courts will be apt to give effect to a reasonable disclaimer clause, if the existence and intended effects of the clause have been comprehended by the buyer.

The Uniform Commercial Code provides the courts with an additional reason, not available under the Uniform Sales Act, for refusing to enforce unreasonable disclaimer clauses. The Code provides, "If the court . . . finds . . . any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result."[45] The Official Comments state: "In the past such policing (of unconscionable contract clauses) has been accomplished by adverse construction of language, . . . or by determination that the clause is contrary to public policy or to the dominant purpose of the contract. This section is intended to allow the court to pass directly on the unconscionability of the contract or particular clause therein. . . ."[46] Many cases used to illustrate the application of this section of the Code involve disclaimer-of-warranty clauses which may be vulnerable to a charge of unconscionability.

Related to the problem of limitation of warranty protection through a contractual disclaimer in a vertical coordination contract is the problem of whether several warranties in a single contract for sale should be cumulative or noncumulative. The Uniform Sales Act declares, ". . . an express warranty or condition does not negative a warranty or condition implied under this act unless inconsistent therewith."[47] This statement fails to take into account the common-law rule that, where a contract is in writing, evidence of express warranties not mentioned in the writing is inadmissible. In contrast, the Uniform Commercial Code provides that, except where a writing is a completely integrated contract, express and implied warranties, whether arising from a writing, an oral statement, or conduct, are admissible and cumulative to the extent that they are consistent with one another.[48] To the extent that express and implied warranties are inconsistent, the Code states that the intent of the parties determines the controlling warranty. The Code provides the following rules for ascertaining intent:

(a) Exact technical specifications displace an inconsistent sample or model or general language of description.
(b) A sample from an existing bulk displaces inconsistent general language of description.

(c) Express warranties displace inconsistent implied warranties other than an implied warranty of fitness for a particular purpose.[49]

In conclusion, a Farmer and Contractor should carefully consider the extent to which they wish to include or exclude warranties from their vertical coordination contracts. Express warranties may be desirable to characterize the product or particular performance under the contract. Implied warranties may be duplicated by express warranties for emphasis. Care should be taken, moreover, in protecting the seller against warranties, whether express or implied, for the disclaimer clauses might be judged to be unconscionable, in which case they would be unenforceable and might reflect on other provisions of the contract.

FOOTNOTES--CHAPTER 5

[1]Vold, Sales § 84 (2d ed. 1959) [hereinafter cited as Vold].

[2]Id. at § 95.

[3]Uniform Commercial Code § 2-312 [hereinafter cited as U.C.C.].

[4]3 Corbin, Contracts § 585 (1960) [hereinafter cited as Corbin].

[5]Uniform Sales Act § 12 [hereinafter cited as U.S.A.].

[6]U.S.A. § 13.

[7]U.S.A. § 69.

[8]Compare 1 Williston, Sales § 213 (rev. ed. 1948) with U.S.A. § 71.

[9]U.C.C. § 2-313.

[10]U.C.C. § 2-312; see 1 Anderson, Uniform Commercial Code 189 (1961).

[11]U.C.C. § 2-313, Comment 1.

[12]Vold § 86, at 428-30.

[13]U.C.C. § 2-313(2).

[14]U.C.C. § 2-313(1)(a).

[15]Vold § 86, at 430-31.

[16]Start v. Shell Oil Co., 202 Ore. 99, 273 P.2d 225 (1954).

[17]U.C.C. § 2-313, Comment 8.

[18]U.C.C. § 2-313(1)(b) and (c).

[19]U.S.A. §§ 14, 16.

[20]U.C.C. § 2-312(1)(a) and (b).

[21]U.S.A. § 13.

[22]Both the Uniform Commercial Code and the Uniform Sales Act make the buyer's need for warranty protection, as evidenced by his reliance on the seller for a warranty, a condition of the existence of a warranty. See Hawkland, Sales and Bulk Sales 40 (1958).

[23]See Restatement, Contracts §368, Illus. 3 (1932).

[24]U.C.C. §§ 2-314, 2-315; U.S.A. § 15.

[25]U.C.C. § 2-104.

[26]See Hall, Article 2 -- Sales -- From Status to Contract"? 1952 Wis. L. Rev. 209, 212.

[27]U.C.C. § 2-314(2).

[28]U.C.C. § 2-315.

[29]Turner v. Kunde, 128 N.W.2d 196 (Iowa 1964).

[30]Cf. Ver Steegh v. Flaugh, 251 Iowa 1011, 103 N.W.2d 718 (1960).

[31]3 Corbin § 585.

[32]U.C.C. § 2-316(1).

[33]See Vold § 91, at 446-47.

[34]U.C.C. § 2-312(2).

[35]U.C.C. § 2-316(2).

[36]Ibid.

[37]Id. at Comment 4.

[38]Id. at Comment 3.

[39]U.C.C. § 2-316(3)(a), (b), and (c).

[40]See Vold § 91.

[41]E.g., Advance-Rumely Thresher Co. v. Jackson, 287 U.S. 283 (1932). (North Dakota statute voids disclaimers of an implied warranty of merchantability with respect to motorized farm equipment).

[42]E.g., Van Wyck v. Allen, 69 N.Y. 61 (1877).

[43]E.g., Larson v. Inland Seed Co., 143 Wash. 55, 255 Pac. 919 (1927).

[44]Ibid.

[45]U.C.C. § 2-302(1).

[46]Id. at Comment 1.

[47]U.S.A. § 15(6).

[48]U.C.C. §§ 2-202, 2-317; see Hawkland, Sales and Bulk Sales 51 (1958).

[49]U.C.C. § 2-317.

CHAPTER 6. RISK OF LOSS OF CONTRACT GOODS

If contract goods are destroyed, damaged, stolen, or lost before the contract is fully performed, the allocation of the risk of loss determines the effect of these circumstances on the parties. If the risk of loss is on the seller, the buyer is excused from paying for destroyed, damaged, stolen, or lost goods. Also, unless the cause of the loss operates to excuse the seller's performance of the contract, he will be liable for damages if he does not obtain other goods to satisfy his obligation to the buyer. On the other hand, if the risk of loss is on the buyer, the buyer must pay the seller the agreed price for the goods even though they have been destroyed, damaged, stolen, or lost and are consequently of little or no use to the buyer.[1]

Under the Uniform Sales Act, the risk of loss generally follows title to the contract goods, unless the parties otherwise agree. On the other hand, the Uniform Commercial Code has several specific provisions which determine without reference to title who bears the risk of loss. Because of their markedly different approaches, the Code and the Sales Act treatments of risk of loss are discussed separately.

THE UNIFORM COMMERCIAL CODE

In determining whether the seller or the buyer bears the risk of loss of contract goods under the Code, it must first be determined whether the parties have agreed who should bear the risk. This agreement may be established by the terms of the contract itself, by relevant trade usage or practice, or by a course of dealing or performance.[2] If they have such an agreement, it will control allocation of the loss,[3] unless this procedure would produce an unconscionable result.[4] The parties ordinarily are free to adjust the risk of loss as they see fit, even though the Code would have treated the subject differently in the absence of an agreement. For example, a vertical coordination contract may provide that the risk of loss of the crop will not pass to the Contractor until the crop reaches the Contractor's processing plant, even though the Farmer is merely required to deliver the goods to a trucking firm. Under the Code, in the absence of this provision, risk of loss would pass to the Contractor when the Farmer delivered the crop to the trucking firm.[5]

If the parties have no agreement concerning risk of loss, the applicable Code provision must be determined. The Code has one specific provision which deals with risk of loss where there has been no breach of contract[6] and another specific provision which deals with risk of loss where a breach of contract did occur.[7] Only questions concerning risk of loss that cannot be resolved on the basis of the agreement of the parties or these two specific sections fall within the provision of the Code dealing with title.[8]

Risk of Loss in the Absence of Breach of Contract

In the absence of breach of contract, the Code distinguishes between (1) contracts which involve delivery of goods to a buyer by an independent carrier-bailee, for example, a railroad, or by the seller himself, (2) contracts which involve the holding of goods for a buyer by an independent non-carrier-bailee, such as a warehouseman, and (3) contracts which involve neither of these features. Moreover, these three types of contracts are further differentiated into subcategories.

Where a contract for sale requires or authorizes the seller to ship the contract goods by an independent carrier-bailee but does not require the seller to assume responsibility for delivery of the goods to a particular destination, the Code provides that the risk of loss passes to the buyer when the goods are duly delivered to the

carrier.[9] Due delivery requires that the seller make a reasonable contract for transportation of the goods to the buyer, that he deliver or offer to deliver to the buyer any documents necessary to obtain possession of the goods from the carrier, and that he promptly notify the buyer of shipment.[10] Thus, if a contract for the production and delivery of livestock authorizes the Farmer to ship the cattle by train from his shipping point, but does not require that the Farmer be responsible for their delivery to the Contractor's packing plant, the risk of loss with respect to the cattle will pass to the Contractor when the Farmer duly delivers them to the railroad.

Conversely, if the contract requires that the Farmer assume responsibility for delivery of the contract goods to a particular destination, the Code provides that the risk of loss does not pass to the Contractor until the goods reach that destination and delivery is offered to the Contractor.[11] An offer of delivery is sufficient, however, and the risk of loss will pass even though an independent carrier-bailee, or the Farmer's agent retains possession of the goods.[12] Thus, if a contract requires delivery of livestock at Omaha, the location of the Contractor's packing plant, the risk of loss would pass after the cattle arrive at a railroad's unloading pens in Omaha and the Farmer (or his agent) offers to turn the cattle over to the Contractor, or after the Farmer's own trucks arrive at Omaha, and the truckers offer delivery of the cattle to the Contractor.

In order to facilitate a determination of whether a contract involving transportation calls for delivery by the seller to a carrier or to a particular destination, the Official Comments to the Code state that a "shipment" contract is to be regarded as normal and a "destination" contract as a variant which must be specifically agreed upon by the parties.[13] The determination is further aided by the Code's definition of certain mercantile terms which relate to the shipment-destination question and control interpretation on this point, unless the parties otherwise agree. For example, a sale f.o.b. (free on board) place of shipment is treated as a shipment contract, and a sale f.o.b. place of destination is treated as a destination contract.[14]

If a vertical coordination contract applies to goods which are in the custody of an independent noncarrier-bailee (for example, cattle held by a stockyard to be picked up there by the Contractor), risk of loss passes to the Contractor when he receives a negotiable document of title to the cattle, or when the noncarrier-bailee acknowledges his right to possession of the cattle.[15] If the Contractor receives a nonnegotiable document of title, or just a written direction to the noncarrier-bailee to deliver the goods to the Contractor, risk of loss does not pass to the Contractor until he has had a reasonable time to present to the noncarrier-bailee the nonnegotiable document of title, or direction to deliver the cattle.[16]

Where a contract involves neither shipment of the contract goods by the seller nor the holding of the contract goods by a noncarrier-bailee, the Code differentiates in the treatment of risk of loss, depending on whether the seller is a merchant. A "merchant" is defined by the Code as a person who deals in goods of the kind sold, or who, by his occupation, holds himself out as having knowledge or skill peculiar to the practices or goods involved in a transaction, or who employs an intermediary who holds himself out as having such knowledge or skill.[17] A Farmer may be a merchant under this definition in some transactions but not in others. The crucial factor is the nature of the goods sold, at least where the Farmer does not employ an intermediary. One writer has suggested "a farmer selling products of his farm would be a merchant, but not were he selling his household goods, and probably not, his farm machinery."[18]

A Farmer-merchant in possession of contract goods that are neither to be shipped nor stored retains the risk of loss until the Contractor actually takes possession of the goods.[19] The reasoning behind this rule is that a Farmer who retains possession of contract goods until a Contractor picks them up is more likely to insure the goods than a Contractor, who has not yet obtained possession.[20] This may be a sound assumption with respect to businessmen-sellers in general, but it is questionable whether the average Farmer-seller would think to insure crops or livestock which have been sold and set aside on the farm for a Contractor to pick up. Nevertheless, under the Code, a Farmer who is considered a merchant bears the risk of loss concerning these goods until the Contractor actually picks them up[21] unless the Farmer is wise enough to stipulate in the contract that the Contractor shall bear the risk of loss prior to actual receipt of the goods.[22] Contrariwise, if the Farmer cannot be considered a merchant with respect to

particular goods sold, the risk of loss of contract goods that are neither to be shipped nor stored by the Farmer passes to the Contractor when the Farmer offers to turn possession of the goods over to the Contractor. Thus, in the absence of a contrary agreement, a nonmerchant Farmer who sells goods to a Contractor can pass the risk of loss to the Contractor by informing him that the goods are ready to be picked up, even though the goods remain in the Farmer's possession.

Effect of Breach of Contract on Risk of Loss

If one of the parties fails to live up to his obligations under a vertical coordination contract, a special provision of the Code governs risk of loss in the absence of a contrary agreement between the parties. This provision generally places the risk of loss on the party who breaches the contract.

A seller typically breaches a contract for sale by failing to supply goods of the type or in the manner required by the contract. Thus, if a vertical coordination contract provided for the production and delivery of 100 head of Angus cattle, to be shipped by train to the Contractor, and the Farmer shipped 100 Hereford cattle by truck, the Farmer would have breached both his obligation to produce Angus cattle and his obligation to deliver them by train. In the event of either type of breach, the Code provides that the risk of loss remains on the Farmer, unless the Contractor accepts the cattle despite the Farmer's breach of contract, or, in the event that the Contractor rejects the cattle, unless the Farmer cures the breach.[23] The Code permits the Farmer to cure a breach of contract if, but only if, there is no contrary agreement and if the time for performance of the contract by the Farmer has not expired, or if the Farmer had reason to believe that the Contractor would accept the goods despite the nonconformity with the contract.[24]

Initial acceptance of the goods does not necessarily preclude a buyer from later revoking acceptance. In the absence of a contrary agreement, the Code permits revocation of a buyer's acceptance of goods that do not conform with the contract and are substantially impaired in their value to the buyer, provided that the buyer accepted the goods on the reasonable assumption that their nonconformity would be cured and this cure has not in fact occurred, or provided that the buyer accepted the goods without discovering their nonconformity because the nonconformity was difficult to discover or because the seller assured the buyer that the goods did conform.[25] In the event of a proper revocation of acceptance, the risk of loss passes back to the seller from the buyer to the extent that the loss is not covered by the buyer's insurance.[26] Thus, if a Farmer accepts a bull for breeding purposes in reliance on a Contractor's good-faith representations concerning the bull's potency, but the bull has in fact become sterile, the Farmer can revoke his acceptance by promptly notifying the Contractor of his intent to do so. If the bull is thereafter struck by lightning and killed, the Contractor will suffer whatever loss is incurred in excess of the Farmer's insurance on the bull. If the bull is not insured by the Farmer, or if the Farmer's insurance does not cover loss caused by lightning, the Contractor will bear the entire loss.

A buyer can breach a contract by failing to perform any obligation imposed by the contract, or by announcing or manifesting in advance an apparent unwillingness or inability to perform. If the buyer commits a breach after the risk of loss has passed to him according to the agreement, or under any of the previously discussed Code provisions which apply in the absence of agreement, the buyer is obviously liable for any subsequent injury to the goods. Moreover, if the buyer commits a breach of contract prior to the time that the risk of loss otherwise would pass to him, and if the seller has set aside conforming goods for performance of the contract, in the absence of a contrary agreement the Code provides that the seller may assume that the risk of loss rests on the buyer for a reasonable time, to the extent that any actual loss to the goods exceeds the seller's insurance coverage.[27] Again, if the goods are uninsured, or if the seller's insurance does not cover the particular type of loss which occurs, the buyer is chargeable with the entire loss.

Title to Contract Goods

The general title provision of the Uniform Commercial Code is important in two situations: (1) Where another section of the Code refers to title; for example, the section dealing with good-faith purchasers makes

the title of a seller important in determining the interest in goods obtained by a buyer;[28] and (2) where a question relevant to title arises that is not treated by a specific provision of the Code; for instance, liability for personal property tax.[29] Because the specific Code provisions dealing with risk of loss do not refer to title, except for an occasional situation which does not fall within the ambit of these specific provisions, title has no relationship to allocation of risk of loss under the Code. Nevertheless, discussion of the Code title provision is warranted at this point because an express agreement of the parties, or a pertinent trade usage, either of which can supersede the Code provisions dealing with risk of loss, may link risk of loss with title.

The Code stipulates that title cannot pass under a contract for sale until specific goods are identified as the subject matter of the contract. It also provides that a reservation of "title" by a seller with respect to goods delivered or shipped to a buyer reserves merely a security interest. With these limitations, ". . . title to goods passes from the seller to the buyer in any manner and on any conditions explicitly agreed on by the parties."[30] Where the parties make no specific agreement on passage of title, the Code provides its own solution. The Code's title rules basically distinguish between contracts which require shipment or storage of goods and those that do not. There are also special provisions dealing with the effect of the buyer's rejection of the goods and the buyer's revocation of acceptance. Some of these gap-filling rules are similar in substance to those contained in the Uniform Sales Act. However, the Code's gap-filling rules apply unless there is a specific contrary agreement by the parties, whereas the Sales Act's rules can be negated wherever and whenever a judge can discern a "contrary intent."[31]

Regarding a contract involving shipment of the goods, the Code presumes that title passes at the time and place at which the seller completes physical delivery of the goods. This transfer of title occurs even though the goods are in the possession of a bailee and a document of title necessary to obtain the goods from the bailee is to be delivered at a different time or place. If a contract authorizes or requires the seller to arrange for shipment of the goods, but does not require the seller to assume responsibility for delivery of the goods to a particular destination, title passes to the buyer at the time and place of shipment.[32] Conversely, if a contract requires the seller to assume responsibility for delivery of the goods to a particular destination by personal delivery or otherwise, title passes on a proper offer of possession at the stipulated destination.[33] If the buyer is to receive the goods from a bailee at this destination, a proper offer of possession includes the offer of a negotiable document which covers the goods in the bailee's possession, or an acknowledgement by the bailee of the buyer's right to possession of the goods. However, the offer of a nonnegotiable document covering the goods in the bailee's possession, or a mere written direction to the bailee to deliver the goods, is nonetheless sufficient, unless the buyer objects or the bailee refuses to honor the document.[34]

Regarding contracts that do not involve shipment, the Code treats as determinative the presence or absence of a requirement that the seller deliver a document covering goods in the possession of a bailee. If the seller is to deliver a document covering goods in the possession of a bailee, title passes at the time and place the document is delivered.[35] On the other hand, if transfer of a document covering goods in the possession of a bailee is not required by the contract, so that the contract goods are presumably in the possession of the seller, and the contract goods are existing and identified at the time of contracting, title passes at the time and place of contracting.[36] Finally, in cases of the buyer's rejection or revoked acceptance of the goods, the Code provides that title ipso facto reverts to the seller by operation of law.[37]

It cannot be overemphasized that the Code's title provisions do not apply to issues covered by other Code provisions. By way of illustration, assume that a Farmer contracts to sell 100 calves to a Contractor, who agrees to transport the calves in his own trucks. The contract does not involve a bailee, and at the time of contracting the calves are segregated in a pasture, so that the general title provision of the Code indicates that title to the calves passes at the time and place where the contract is made.[38] Nevertheless, if the Farmer regularly deals in calves and if the contract is silent as to the risk of loss, another specific provision of the Code declares that the risk of loss remains on the Farmer until the Contractor picks up the calves.[39]

Identification of Goods

The concept of identified goods runs through the risk-of-loss and title provisions of the Code. Nonidentification of contract goods is an absolute bar to the passage of title, regardless of an explicit agreement to the contrary,[40] and the risk of loss may not pass until the contract goods are identified.[41] Still another Code section provides that identification of the contract goods creates in the buyer a special property interest, which, among other things, is an insurable interest.[42] Of course, the seller also ordinarily has an insurable interest in contract goods as long as he retains either possession, title, or a security interest.[43]

Identification of the contract goods can be made at any time and in any manner explicitly agreed to by the parties. In the absence of an explicit agreement, the Code defines when identification occurs.[44] Identification of specific existing goods occurs when a contract for sale is made, regardless of whether the goods are in a deliverable state.[45] Thus, the sale of a part of an existing fungible (interchangeable) bulk of goods, for example, the sale of 100 bushels of grain from an elevator containing thousands of bushels of grain, is a sale of identified goods, even though the grain sold must be segregated and removed from the elevator prior to delivery.[46] Under a contract for sale of goods not yet in existence, identification ordinarily occurs when the ". . . goods are shipped, marked or otherwise designated by the seller as goods to which the contract refers . . . ."[47] An exception to this rule applies to certain crops and livestock. Crops are considered identified when they are planted, and the unborn young of specific livestock are considered identified when conceived, provided the contract is for the sale of unborn young to be born within 12 months of contracting, or for the sale of crops to be harvested within 12 months, or the next normal harvest season, whichever is longer.[48]

The importance of the inclusion of certain growing crops and unborn livestock in the concept of identified goods is obvious. If a contract provides for the sale of unborn calves of specific livestock, for example, both the Farmer and the Contractor will ordinarily be able to insure the calves to be born within a year of the making of the contract.[49] Title to the unborn calves can pass at the time of making the contract, if the calves are not to be shipped or bailed,[50] or regardless of these circumstances, if the parties expressly so provide.[51] Furthermore, if the Contractor should repudiate the contract prior to the birth of the calves, the Farmer may assume that risk of loss rests on the Contractor for a reasonable time to the extent the Farmer is not protected by insurance.[52] The same, of course, holds true for a sale of specific growing crops yet to be harvested to the extent that these fall within the definition of identified goods.

THE UNIFORM SALES ACT

Under the Uniform Sales Act, a considerable number of sales problems are resolved on the basis of title. The holder of title, for example, is generally considered to bear the risk of loss, and the buyer does not obtain an insurable interest until title passes to him.[53]

Despite the overriding significance of the title concept under the Uniform Sales Act, the Act uses the term "property" instead of "title" in its treatment of transfer of ownership from seller to buyer. This usage was employed for technical reasons which in no way derogate from the importance of title under the Act.[54]

The general rule under the Sales Act is that property in specific and ascertained goods passes when the parties so intend,[55] whereas a transfer of property in unascertained goods is ordinarily impossible, regardless of the parties' intent, until the specific goods sold have been ascertained.[56] This rule has been described as a rule of logic rather than a rule of law, the proposition being that it is meaningless to talk of a sale of unascertained goods.[57] The Sales Act's notion of "unascertained" goods is analogous to the Code's notion of unidentified goods. The Sales Act, for instance, defines "specific goods," the opposite of unascertained goods, as goods "identified and agreed upon at the time that a contract to sell or a sale is made."[58] The principal exception to the rule that no property in unascertained goods can be passed relates to the sale of a share in a mass of fungible (interchangeable) goods where the precise goods purchased are to be ascertained at a later time.[59] Thus, a contract for the sale of an interest in 100 bushels of

wheat among thousands of bushels of wheat in a grain elevator can create an interest in the buyer in 100 bushels of wheat, even though the 100 bushels are not segregated and removed from the elevator.[60] However, if the parties actually mean to sell the 100 bushels of wheat outright, property cannot pass until the specific bushels sold are ascertained.

Where contract goods are specific and ascertained, the Sales Act requires the courts to attempt to determine the intention of the parties with respect to the transfer of property from the terms of the contract, the conduct of the parties, usages of trade, and the circumstances of the case.[61] Thus, if a contract provides that the ownership of male and female hybrid seed corn passes when the Farmer picks it up at the Contractor's office, this explicit agreement should control. If a contract does not have an express provision dealing with the transfer of property, the intent of the parties may be inferred from related terms of the contract; for instance, a declaration that the Farmer bears the risk of loss of seed that he picks up indicates a transfer of property at that time. In the absence of a determinative contract provision, delivery of the goods by the seller suggests relinquishment of property. Similarly, payment of all or substantially all of the purchase price at the time that a contract is made suggests a contemporaneous transfer of property. Finally, as in Wheatley v. H. & H. Poultry Co.,[62] trade usage may indicate the parties' intent. In the Wheatley case, 13,000 broilers were sold, with the total purchase price to be based on the number of "live weight" birds. The buyer picked up some of the birds, but before he returned for the others 2,000 of them smothered to death. When the buyer's obligation to pay for the dead birds was taken to court by the seller, the court found that the property in broilers bought by "live weight" would not pass, according to trade custom, until the buyer had selected the birds that he wanted, and that the seller consequently bore the risk of loss of the dead birds.

Where the parties have no discernible intent concerning the transfer of property, the Sales Act, like the Code, provides statutory presumptions. According to critics, however, the Sales Act's presumptions emphasize what the parties have done rather than what they agreed to do and are nebulous and conflicting.[63]

In the case of an unconditional contract for the sale of specific and ascertained goods that are in a deliverable state, the Sales Act presumes that property passes to the buyer when the contract is made, even though the time of payment, or the time of delivery, or both are postponed.[64] Goods in a deliverable state are goods that are in the condition contemplated by the contract.[65] Thus, 20 bushels of unthreshed wheat are not in a deliverable state if the contract calls for 20 bushels of threshed wheat, so the property in the wheat will not be presumed to pass when the contract is made, even though the wheat is existing and identified at that time and the contract is unconditional. A conditional contract is a contract that is not binding unless certain operative facts occur.[66] For example, if a contract makes a buyer's obligation to accept and pay for Black Angus calves dependent upon the seller's herd being the major winner at the local fair, the contract is conditional and property will not be presumed to pass when the contract is made, even though the calves are specifically identified and in a deliverable state at that time.

If a contract to sell specific and ascertained goods requires that the seller put the goods in a deliverable state, as in many vertical coordination contracts, the Sales Act presumes that property does not pass to the buyer until the goods are in a deliverable state.[67] For instance, if a contract for the sale of calves requires the seller to immunize the calves from a specific disease before delivery to the buyer, the property in the calves would not be assumed to pass to the buyer until immunization occurs.

One of the criticisms of the two Sales Act presumptions relating to specific and ascertained goods is that a choice between them can depend on whether the contract goods are considered to be in a deliverable state, and that the courts have differed in making this choice. Thus, where an unconditional contract for the sale of specific and ascertained fowl requires weighing, grading, and sorting of the fowl prior to delivery, but the fowl are frozen or smother before this is done, some courts nonetheless have held that property and the risk of loss passed to the buyer when the contract was made. Weighing, grading, and sorting, which are possible despite the death of the fowl under the above circumstances, were treated as matters of routine that were unnecessary to place the fowl in a deliverable state.[68] Yet, where similar contracts were involved and the birds were

destroyed by fire prior to weighing, grading, and sorting, some of these same courts have treated weighing, grading, and sorting as necessary to place the fowl in a deliverable state--perhaps because the incineration of the fowl precluded weighing, grading, and sorting after their loss, which in turn prevented ready determination of the total purchase price.[69]

The presumptions just discussed deal with specific and ascertained contract goods. If the contract goods are unascertained, either because they are not yet in existence or simply because they have not been identified, other Sales Act presumptions govern the transfer of property. The property in unascertained goods is ordinarily presumed to pass when goods are unconditionally appropriated to the contract.[70] "Appropriation" is defined in the cases cited as mutual assent by the parties that the property in specific goods shall pass to the buyer.[71] The mutual assent that particular goods conform to the contract, which is essential to appropriation, can occur before, as well as after, the specific goods are identified.[72] Thus, if a contract for the sale of "top-quality" sweet corn is made before the corn is planted, and the buyer agrees to accept all the mature corn selected by the seller as top-quality, appropriation occurs when the seller subsequently selects the top-quality corn.

Where there is a contract for sale of unascertained goods, and the seller subsequently delivers specific goods conforming to the contract to the buyer himself, or to a bailee who will store or transport the goods for the buyer, the parties are ordinarily presumed to have unconditionally appropriated the goods to the contract.[73] However, two statutory exceptions to this presumption exist insofar as delivery to a bailee is concerned. If the seller expressly retains property in the goods in his transaction with a bailee, unconditional appropriation does not occur through delivery to the bailee.[74] For example, if a seller delivers previously unascertained potatoes to a railroad for transportation to the city where the buyer is located, and the seller names himself as both consignor and consignee in the bill of lading, the delivery of the potatoes to the railroad does not constitute unconditional appropriation.[75]

The second exception applies where obligations concerning shipment are placed on the seller. Thus, if a contract for the sale of unascertained goods specifically requires the seller to deliver the goods to the buyer, or to a specified place, or if the contract requires the seller to pay the cost of transportation to the buyer, or to a specified place, property is not deemed to pass to the buyer until the seller completes the stipulated performance with respect to shipment.[76] This exception applies only when it is determined that a seller has certain shipment obligations. Such determination is sometimes difficult, especially if the parties indicate the shipment terms through the use of mercantile symbols. For example, the designation "f.o.b. delivery point" may be interpreted to mean either that the buyer requires the seller to deliver the goods to a specified place, so that property does not pass until that time, or that the buyer pays the cost of transportation through an adjustment in the price, so that title consequently passes when the seller delivers the goods to a bailee for shipment.[77]

In the absence of a contrary agreement, risk of loss normally follows the property in the goods under the Sales Act,[78] with two exceptions. If delivery of the goods is made to the buyer, or to a bailee for the buyer, and the seller retains title merely as security for the buyer's performance of his obligations, the risk of loss is presumed to pass to the buyer.[79] This exception would hold for instance, where goods conforming to the contract are shipped by the seller consigned to himself at the buyer's location. The seller takes out a bill of lading in his own name purely for security purposes; the buyer bears the risk of any loss caused, for example, by a train wreck.[80] The other exception applies where delivery of the contract goods is delayed through the fault of either the seller or the buyer. In this event, any loss caused by the party at fault falls on that party, regardless of who technically has the title in the goods.[81] It is important to realize that this exception only covers a situation where one of the parties unjustifiably causes a delay in delivery; for example, where a buyer requires the seller to deliver the goods to the buyer's actual place of business in the contract for sale, but then furnishes misleading oral information as to the location of that place of business, resulting in a delay in delivery. Unlike the analogous Code provisions, the exception does not apply if either the seller or the buyer totally repudiates his contractual obligations.[82]

[1] Whitney, Law of Modern Commercial Practices § 234 (1958).

[2] Uniform Commercial Code § 2-509, Comment 5 [hereinafter cited as U.C.C.].

[3] U.C.C. § 2-509(4).

[4] U.C.C. § 2-302.

[5] U.C.C. § 2-509(1)(a).

[6] U.C.C. § 2-509.

[7] U.C.C. § 2-510.

[8] U.C.C. § 2-401.

[9] U.C.C. § 2-509(1)(a).

[10] U.C.C. § 2-509, Comment 2; § 2-504.

[11] U.C.C. § 2-509(1)(b).

[12] Ibid.

[13] U.C.C. § 2-503, Comment 5.

[14] U.C.C. § 2-319(1)(a) and (b). Other terms defined in the Code are "F.O.B. (free on board) vessel, car or other vehicle," § 2-319(1)(c); "F.A.S." (free alongside), § 2-319(2); "C.I.F." (cost, insurance, and freight), and "C. & F." § 2-320; "Net Landed Weights," "Payment on Arrival," and "Warranty of Condition on Arrival," § 2-321; and "Ex-Ship," § 2-322.

[15] U.C.C. § 2-509(2)(a) and (b).

[16] U.C.C. §§ 2-509(2)(a)(c); 2-503(4)(b).

[17] U.C.C. § 2-104(1).

[18] Hall, Article 2 -- Sales -- "From Status to Contract"? 1952 Wis. L. Rev. 209, 212. The Official Comments to an early version of the Uniform Commercial Code explicitly stated that a farmer was a merchant with respect to sales of his customary cash crops. See Latty, Sales and Title and the Proposed Code, 16 Law and Contem. Prob. 3, 15N. 50 (1951).

[19] U.C.C. § 2-509(3).

[20] U.C.C. § 2-509, Comment 3.

[21] U.C.C. § 2-509(3).

[22] Ibid.

[23] U.C.C. § 2-510(1).

[24] U.C.C. § 2-508.

[25] U.C.C. § 2-608.

[26] U.C.C. § 2-510(2).

[27] U.C.C. § 2-510(3).

[28] U.C.C. § 2-403.

[29] U.C.C. § 2-401, Comment 1.

[30] U.C.C. § 2-401(1).

[31] Compare U.C.C. § 2-401(2) with Uniform Sales Act § 19 [hereinafter referred to as U.S.A.].

[32] U.C.C. § 2-401(2)(a).

[33] U.C.C. § 2-401(2)(b).

[34] U.C.C. § 2-503(4).

[35] U.C.C. § 2-401(3)(a).

[36] U.C.C. § 2-401(3)(b).

[37] U.C.C. § 2-401(4).

[38] U.C.C. § 2-401(3)(b).

[39] U.C.C. § 2-509(3).

[40] U.C.C. § 2-401(1).

[41] See U.C.C. § 2-510(3).

[42] U.C.C. § 2-501(1). Other incidents of this special property interest are referred to in U.C.C. § 2-401, Comment 3.

[43] U.C.C. § 2-501(2) makes clear that the insurable interest in the buyer does not negate an insurable interest in the seller, as long as the seller retains title or a security interest in the goods.

[44] U.C.C. § 2-501(1).

[45] U.C.C. § 2-501(1)(a) and Comment 4.

[46] U.C.C. § 2-501, Comment 5.

[47] U.C.C. § 2-501(1)(b). If identification is by the seller alone, he can substitute other goods for those identified, until default, insolvency, or notification to the buyer that identification is final. U.C.C. at § 2-501(2).

[48] U.C.C. § 2-501(1)(c).

[49] U.C.C. § 2-501.

[50] U.C.C. § 2-401(3)(b).

[51] U.C.C. § 2-401(1).

[52] U.C.C. § 2-510(3).

[53] Hawkland, Sales & Bulk Sales 79, 96 (1958) [hereinafter cited as Hawkland].

[54] Whitney, Law of Modern Commercial Practices § 235 (1958).

[55] U.S.A. § 18E.

[56] U.S.A. § 17.

[57] 2 Williston, Sales § 258 (rev. ed. 1948).

[58] U.S.A. § 76.

[59] U.S.A. § 17.

[60] U.S.A. § 6.

[61] U.S.A. § 19; see generally Vold, Sales § 24 (2d ed. 1959) [hereinafter cited as Vold].

[62] U.S. Del. (6 Terry) 502, 75 A.2d 702 (1950).

[63] E.g., Hawkland 80, 85.

[64] U.S.A. § 19(1).

[65] Vold § 25.

[66] 3A Corbin, Contracts § 627 (1960).

[67] U.S.A. § 19(2).

[68] E.g., Radloff v. Bragmus, 214 Minn. 130, 7 N.W. 2d 491 (1943).

[69] Hawkland 80-8.

[70] Hawkland 84.

[71] Ibid.

[72] U.S.A. § 19(4)(1).

[73] U.S.A. § 19(4)(2).

[74] Ibid and U.S.A. § 20.

[75] 2 Williston, Sales § 283.

[76] U.S.A. § 19(5).

[77] Hawkland 85-87. Similar problems arise with respect to other mercantile symbols. Id. at 87-88.

[78] U.S.A. § 22.

[79] U.S.A. § 22(a).

[80] 2 Williston, Sales § 305.

[81] U.S.A. § 22(b).

[82] 2 Williston, Sales § 306.

CHAPTER 7. IMPOSSIBILITY OF PERFORMANCE

As indicated in the chapter on Risk of Loss of Contract Goods, allocation of risk of loss principally determines whether the buyer is obligated to pay for contract goods that have been destroyed or damaged. If the buyer is not so obligated because the seller bears the risk of loss, does the destruction or damage of the contract goods excuse the seller from further performance? This is one of several questions affected by the legal doctrine of impossibility of performance. Where a promised performance has become impossible, illegal, dangerous, difficult, or expensive, this doctrine determines whether a party will be excused from liability for breach of contract if he fails to perform.[1] The doctrine originated at common law, but both the Uniform Sales Act and the Uniform Commercial Code have crystallized aspects of it.

DESTRUCTION OF SPECIFIC CONTRACT GOODS

Where there is a contract for the sale of identified goods, and the goods are totally destroyed without fault of either party before the risk of loss passes to the buyer, both parties are excused from further performance by both the Sales Act and the Code.[2] If a Farmer who contracted to deliver beans to a Contractor has a total crop failure, the Farmer, nevertheless, may be liable for breach of contract if he fails to deliver the beans on time, unless the Farmer unequivocally limited his promise to beans that he himself was able to produce, or to the beans produced on a specified acreage of land. On the other hand, if the Farmer had contracted to deliver "the beans produced on my north forty" and then suffered a crop failure, the Sales Act and the Code would excuse the Farmer from further performance.

As this illustration shows, a Farmer is wise to specify the precise goods which he intends to sell, so that he can take maximum advantage of the doctrine of impossibility if the goods are unavailable without his fault. Judges tend to consider that Farmers contract with respect to specific goods, even if they do not say so clearly,[3] but "an ounce of prevention" may avoid a law suit over the question. Of course, if one or the other of the parties is responsible for destruction of the goods, that party will not be relieved of his contractual obligations by his act. Thus, if a Farmer's negligence leads to a fire which destroys the contract goods, he will, nevertheless, be liable in damages, unless he delivers goods conforming to the contract to the buyer.

If specific contract goods are partially destroyed or damaged before the risk of loss passes to the buyer, both the Sales Act and the Code give the buyer an option. The Sales Act allows the buyer to treat the contract as abandoned, or to require the seller to deliver all or part of the goods for the full price if the contract is indivisible, or for a ratable portion of the price if the contract is divisible.[4] In a divisible contract, the performance of both parties is divided into "pairs of separate agreed equivalents".[5] For example, if a seller agrees to sell eight calves at $150 apiece, with each calf to be delivered and paid for on a separate date, the contract might be considered divisible, with the delivery and payment for each calf constituting a separate pair of agreed equivalents. On the other hand, the contract might be considered indivisible if the buyer established that the seller knew the buyer needed all eight calves in the condition specified by the contract in order to fulfill his purpose in making the contract.[6]

The difficulty, and consequent inconsistency, in applying the divisible and indivisible distinction under the Sales Act led to its deletion from the option given a buyer by the Code in the event of partial destruction or damage to the contract goods. If contract goods are partially destroyed or damaged without fault of either party before the risk of loss passes to the buyer, the Code permits the buyer

either to treat the contract as abandoned, or to accept the goods with due deduction from the contract price for any deficiency in quality or quantity.[7] Under both the Sales Act and the Code, the buyer's option to treat the contract as abandoned, or to accept partly destroyed or damaged goods, exists solely with respect to specific contract goods. If the contract goods have not been singled out when loss occurs to some of the goods from which the seller might have selected the contract goods, the seller must select other goods that conform to the contract, or commit a breach; the opportunity for the buyer to exercise an option does not arise.

FAILURE OF PRESUPPOSED CONDITIONS

The common law doctrine of impossibility of performance is substantially unaltered by the Sales Act, insofar as it excuses a seller from performing because of the erroneous nature, or subsequent failure, of a basic assumption on which the contract was made. If goods contracted to be sold are destroyed or damaged, without the parties' knowledge, before the contract is made, the Sales Act treats the situation in the same manner as the previously discussed situation, where the goods are destroyed or damaged after the contract is made. Thus, if a farmer agrees to sell 10 tons of baled hay, ignorant of the fact that the barn containing the hay had burned the day before, the Sales Act excuses the farmer from liability for breach of contract when he fails to deliver the hay.[8] If only part of the hay is destroyed, the Sales Act gives the buyer the option of abandoning the contract, or accepting the portion of the hay that conforms to the contract and paying the full contract price if the contract is indivisible, or a ratable portion of the price if the contract is divisible.[9] Otherwise, the Sales Act does not deal with consequences of failure of basic assumptions. The common-law principles which govern these consequences in Sales-Act jurisdictions distinguish between subjective and objective impossibility and material and immaterial impossibility.

Subjective impossibility refers to the personal inability of a promisor to carry out his promise, whereas objective impossibility exists where a promised performance could not be rendered by anybody.[10] Only objective impossibility excuses a contractual obligation.[11] Thus, a workman who agrees to drive logs down a stream will ordinarily be excused from liability if the stream dries up, but a farmer who agrees to sell 10 bushels of corn will not be relieved of his obligation if he cannot obtain sufficient funds with which to purchase the necessary seed and fertilizer. In the latter instance, the nonperformance is personal to the particular farmer.

Material impossibility refers to the nonexistence of a condition, or a means of performance, contemplated by the parties as necessary to the performance of their contract, whereas immaterial impossibility refers to a condition, or a means of performance, that may be mentioned in the contract but is not necessary to fulfillment of the agreed exchange.[12] Obviously, material impossibility will, and immaterial impossibility will not, excuse a contractual obligation. The way in which a condition or a means of performance is described in the contract helps to determine the condition's importance. If a contract provides that a Farmer must ship okra in refrigerated railroad cars and that shipment by refrigerated truck will not be satisfactory, the Farmer will be excused from liability if a strike prevents any railroad shipments during the stipulated period. On the other hand, if the contract refers to shipment by train without precluding other modes of shipment, and if a strike precludes rail shipment, the Farmer will be liable for breach of contract if he fails to utilize refrigerated trucks that are available and can accomplish delivery equally well.[13] Moreover, it is not determinative that arranging a last-minute delivery by truck may be more expensive for the Farmer, if he was aware of the possibility of a railroad strike. The occurrence of foreseeable events that increase the difficulty and expense of performance is not an excuse for nonperformance.[14] Sometimes a particular condition or mode of performance will be so clearly necessary to the performance of a contract that its nonexistence will obviously result in objective impossibility even though the parties have not said so in so many words. Thus, where a farmer agrees to ship a perishable product a long distance, a refrigerated means of transportation will be necessary, whether shipment is by rail or truck. Similarly, a

judge found a farmer's performance excused, where he had agreed to lease and cultivate a tract of land in a manner that proved impossible because of the high alkaline and salt content of the soil.[15]

The above discussion assumes that impossibility is total where it exists. Impossibility may also be partial, for example, a fire destroys half of a Farmer's broilers. If these broilers are the subject of several contracts for sale and the remaining broilers can be used to completely fulfill some but not all of the contracts, at common law the Farmer is usually considered obligated to prorate his remaining broilers among all the Contractors, in order to successfully assert a defense of impossibility with regard to any of them.[16]

Like the Sales Act, the Uniform Commercial Code treats inadvertent total or partial destruction of specific contract goods before a contract for sale was made in the same fashion as subsequent unavoidable casualty to the goods.[17] However, unlike the Sales Act, the Code codifies a number of the other rules concerning the doctrine of impossibility. First, the Code has a provision requiring a seller to utilize an available, commercially reasonable substitute for the mode of delivery specified in the contract if the specified mode of delivery is unavailable without fault of either party.[18] The most far-reaching aspect of these Code provisions, however, is contained in the following two sections. Section 2-615 states:

> Except so far as a seller may have assumed a greater obligation. . . :
>
> (a) Delay in delivery or non-delivery in whole or in part by a seller who complies with paragraphs (b) and (c) is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid. (b) Where the causes mentioned in paragraph (a) affect only a part of the seller's capacity to perform, he must allocate production and deliveries among his customers but may at his option include regular customers not then under contract as well as his own requirements for further manufacture. He may so allocate in any manner which is fair and reasonable. (c) The seller must notify the buyer seasonably that there will be delay or non-delivery and, when allocation is required under paragraph (b), of the estimated quota thus made available for the buyer.[19]

Although the above section of the Code treats the doctrine of impossibility of performance from the standpoint of the seller, the Official Comments indicate that analogous principles should be applied to events which frustrate the buyer's purpose in entering the contract.[20] For example, if a canner agrees to buy a crop of tomatoes in the expectation of canning and reselling them, and his cannery is destroyed by a flood prior to delivery of the tomatoes, the canner may be excused from his obligation to accept and pay for the tomatoes because of the inadvertent frustration of his purpose in entering into the contract of sale.

Section 2-616 states:

> (1) Where the buyer receives notification of a material or indefinite delay or an allocation justified under the preceding section he may by written notification to the seller as to any delivery concerned, and where the prospective deficiency substantially impairs the value of the whole contract. . . then also as to the whole,
>
> (a) terminate and thereby discharge any unexecuted portion of the contract; or
>
> (b) modify the contract by agreeing to take his available quota in substitution.
>
> (2) If after receipt of such notification from the seller the buyer fails so to modify the contract within a reasonable time not exceeding thirty days the contract lapses with respect to any deliveries affected.
>
> (3) The provisions of this section may not be negated by agreement except in so far as the seller has assumed a greater obligation under the preceding section.[21]

AGREEMENT BETWEEN THE PARTIES

Contract parties are free to contract with respect to the consequences of supervening impossibility. It is possible, for instance, for a party to guarantee that his promised performance is not and will not become impossible. If objective impossibility later occurs where such a promise is made, the promisor will, of course, be liable for damages. Thus, a farmer who agrees to supply pasturage on specific land for a specified number of cattle, guaranteeing that grass and water will be available, will be liable for damages in the event of drought.[22] It is more common, however, for the parties to insert contract clauses explicitly disclaiming contractual liability in the event of objective impossibility. Despite the existence of the doctrine of impossibility, contracts may contain clauses dealing with contingencies that will excuse a contractual obligation. These clauses can limit the availability of the excuse of impossibility at common law, and under both the Sales Act and the Code, so the parties should scan them closely to make sure that they are adequate and fair. It is probably typical for these "nonliability" clauses to be broadly phrased and to include a catchall phrase excluding liability for "all other causes beyond our control" which prevent performance.[23]

Nonliability clauses allow the parties to allocate the risks of impossibility in the manner that they desire, but these clauses are also subject to abuse. A person in a strong bargaining position may force the adoption of a broad nonliability clause limited to his own obligations. In extreme situations, these one-sided clauses may go so far as to be unconscionable and invalid under the Code,[24] and may result in invalidation of the entire contract in both Code and Sales-Act jurisdictions.[25] Alternatively, judges may tone down a broad and one-sided clause by, in effect, applying its terms to both parties to the contract,[26] or by narrowing its compass through interpretation.[27] The Wisconsin case of Strong v. Shawano Canning Co.[28] illustrates the related principle that a contracting party whose conduct makes a contract impossible to perform cannot rely on a nonliability clause to excuse his own contractual obligation.

FOOTNOTES--CHAPTER 7

[1] 6 Corbin, Contracts § 1322 (1962) [hereinafter cited as Corbin].

[2] Uniform Sales Act § 8(1); Uniform Commercial Code §2-613(a) [hereinafter cited as U.S.A. and U.C.C.].

[3] Note, 53 Colum. L. Rev. 94, 101-02 (1953).

[4] U.S.A. § 8(2).

[5] 3A Corbin § 688, at 248.

[6] Id. § 699, at 307.

[7] U.C.C. § 2-613(b).

[8] U.S.A. § 7(1).

[9] U.S.A. § 7(2).

[10] 6 Corbin § 1332, at 361.

[11] Id. § 1332.

[12] See Id. § 1339.

[13] Id. § 1339, at 403-04.

[14] Id. § 1333, at 370.

[15] Faria v. Southwick, 81 Idaho 68, 337 P.2d 374 (1959).

[16] 6 Corbin § 1342.

[17] U.C.C. § 2-613, Comment 2.

[18] U.C.C. § 2-614(1). Section 2-614(2) applies similar principles where either the agreed means or manner of payment fails because of a domestic or foreign governmental regulation.

[19] U.C.C. § 2-615.

[20] U.C.C. § 2-615, Comment 9.

[21] U.C.C. § 2-616.

[22] 6 Corbin § 1339, at 398.

[23] 3A Corbin § 642.

[24] U.C.C. § 2-302.

[25] Ibid.; 3A Corbin § 642, at 74.

[26] 3A Corbin § 642, at 73.

[27] E.g., Oosten v. Hay Haulers Dairy Employees and Helpers Union, 45 Cal. 2d 784, 291 P.2d 17, cert. den., 351 U.S. 937 (1955).

[28] 13 Wis. 2d 604, 109 N.W. 2d 355 (1961).

CHAPTER 8. BREACH OF CONTRACT

The principal remedies authorized by law for breach of contract are self-help, compensatory damages, restitution, and specific performance.[1] The contracting parties can supplement and, to some degree, restrict the availability of these remedies by the terms of their contract; but, even if a contract expressly deals with remedies, some or all of the remedies authorized by law will nonetheless usually be available to redress a breach.

Self-help is essentially a legally privileged refusal to perform contractual obligations by a nonbreaching party to a contract.[2] For instance, if a seller breaches his contract by failing to deliver the contract goods on time, the buyer may be privileged to refuse payment of the contract price. The most common judicial remedy for breach of contract is an award of compensatory damages intended to put a nonbreaching party in as good a position as if the contract had been performed.[3] In contrast, the judicial remedy of restitution attempts to put a nonbreaching party in as good a position as he enjoyed prior to entering the contract,[4] and the judicial remedy of specific performance endeavors to grant the promised performance itself to a nonbreaching party.[5]

This discussion of the remedies for breach of contracts focuses on the respective remedies of sellers and buyers. Both are highly relevant to vertical coordination contracts in which a Farmer agrees to buy inputs from a Contractor, or to sell outputs to a Contractor, or to do both.

SELF-HELP

If either a seller or a buyer breaches a vertical coordination contract, self-help is the most expeditious and inexpensive remedy available to the nonbreaching party. However, it must be emphasized that self-help is <u>not</u> a legally privileged response to every breach of contract. A serious and substantial breach ordinarily must occur for self-help to be privileged. In the case of a contract involving delivery of goods in installments, a breach with regard to one or only a few installments may merely create an equally limited privilege. If a seller or buyer attempts to utilize a minor or inconsequential breach of contract by the other party as an excuse for total nonperformance, the unjustified resort to self-help may itself constitute a breach of contract.[6] Moreover, the Uniform Commercial Code and the Uniform Sales Act have express provisions dealing with self-help which further condition its availability. The Code and the Sales Act deal with the following aspects of self-help: A seller's privilege to retain possession of the contract goods; a seller's privilege to cancel the contract for sale; a seller's privilege of resale; a buyer's privilege to reject goods that do not conform to the contract; a buyer's privilege to cancel the contract; and a buyer's privilege of cover.

Seller's Privilege of Self-Help

A seller may be privileged to retain possession of the contract goods as security for the buyer's payment of the purchase price. The Sales Act makes a technical distinction, referring to exercise of this privilege before the property in the goods passes to the buyer as "withholding delivery," and referring to exercise of this privilege after property in the goods passes to the buyer as an "unpaid seller's lien."[7] The Code, consonant with its lack of emphasis on title, simply speaks of a seller's right to "withhold delivery."[8] The following discussion utilizes the Code terminology.

The Sales Act deals only with an unpaid seller's privilege of withholding delivery, although court decisions in Sales Act jurisdictions recognize an analogous seller's privilege if a buyer breaches a contract in some other manner.[9] The Sales Act

authorizes a seller to withhold delivery until an offer of cash payment is made by the buyer, regardless of the passage of property to the buyer, in the following situations:

Where the goods were sold without any stipulation as to credit;

Where the goods were sold on credit, but the term of credit has expired;

Where the buyer becomes insolvent.[10]

In contrast, the Code extends statutory recognition of a seller's privilege of withholding delivery to situations in which a buyer breaches by wrongful rejection of goods, by wrongful revocation of acceptance of goods, and by advance repudiation of his contractual obligation, in addition to breaches caused by nonpayment or insolvency.[11] Exercise of the privilege of withholding delivery under either the Code or the Sales Act, it should be mentioned, leaves a seller free to utilize other remedies for breach of contract against the buyer.[12]

A corollary of a seller's privilege to withhold delivery is his privilege to stop delivery after the goods are turned over to a bailee for transportation or storage. Contrary to the Sales Act, which merely allows a seller to stop delivery by a carrier if the buyer stops paying his debts or cannot pay his debts as they come due,[13] the Code authorizes a seller to stop delivery of the contract goods to the buyer by warehousemen, as well as by carriers, when the buyer is insolvent, either in the Sales Act meaning or in the sense that the buyer's total debts exceed his total assets, regardless of whether the buyer is paying his current bills.[14] Furthermore, a Code provision, which has no counterpart in the Sales Act, allows a seller to stop delivery of carload, truckload, planeload, or larger shipments in the hands of bailees, if the buyer commits any material breach of contract.[15] Though the two uniform acts differ markedly in the scope given to a seller's privilege to stop delivery, both indicate that the effect of exercising this privilege is to place a seller in the position that he occupied prior to turning the goods over to a bailee.[16]

Another form of self-help recognized by the Sales Act and the Code is a seller's privilege to cancel a contract following a substantial breach of contract by the buyer.[17] Exercise of this privilege naturally requires restoring or crediting to the buyer any payment or other performance received by the seller under the contract. The Sales Act has two different provisions relevant to the privilege of cancellation, but neither one applies once the contract goods are delivered to the buyer. If the property in the goods has passed to the buyer, an unpaid seller who exercised privilege to withhold delivery or a privilege to stop shipment is allowed to cancel unilaterally the transfer of property and to sue the buyer for compensatory damages, provided that the seller does so openly and the buyer has been in default in payment for an unreasonable time.[18]

If the buyer totally repudiates his contractual obligations prior to the time that they are due, if he manifests an inability to perform, or if he commits any material breach of contract before delivery of the goods,[19] another section of the Sales Act privileges a seller to cancel the contract on notice to the buyer. This latter section, like the Sales Act section dealing with cancellation of the transfer of property alone, results in the cancellation of any transfer of property that has taken place, if the privilege to cancel the entire contract for sale is exercised. Nonpayment by the buyer would also constitute as much of a violation of the latter section as the former. The crucial distinction between the two Sales Act sections is that a seller who exercises the broader and more readily available privilege to cancel the contract is ordinarily deemed to have waived any right to compensatory damages,[20] whereas a seller who exercises the limited privilege of canceling the transfer of property on the ground of nonpayment is considered to have manifested an intention to maintain the contract in effect and is also allowed to sue for compensatory damages.[21]

These Sales Act provisions may unfairly penalize sellers. Thus, a Farmer-seller who is still in possession of contract soybeans, the property in which has passed to the Contractor, may desire to cancel the contract after learning that the Contractor-buyer is going broke. Yet, if the Farmer does cancel, he cannot recover damages from the Contractor to the extent that the market price of soybeans has dipped below the contract price. Moreover, although the Farmer may be wise enough to know that a mere cancellation of the transfer of property will still permit him to recover damages, he cannot cancel this transfer unless and until the buyer has defaulted in payment for an unreasonable time, even though the bottom may fall out of the soybean market during this interval, or the Contractor may become so broke that a

right to collect damages from him would be worthless. The Code does away with this dilemma by dropping the false distinction between cancellation of a transfer of property and cancellation of a contract for sale. The Code permits a seller both to cancel a contract for sale and to recover compensatory damages for a variety of reasons, including the buyer's wrongful rejection of contract goods, wrongful revocation of acceptance of contract goods, failure to make a payment due on or before delivery, and repudiation of his contractual obligations.[22]

The Code provisions on cancellation have still another advantage over those in the Sales Act. As previously mentioned, the Sales Act does not permit cancellation by a seller once the goods are delivered to the buyer.[23] The Code, on the other hand, allows cancellation where the buyer wrongfully rejects or wrongfully revokes acceptance of delivered goods.[24] Moreover, if the seller discovers that the buyer has received goods on credit while insolvent, the Code authorizes the seller to reclaim the goods within 10 days after delivery, or at any time if within the 3 months preceding delivery the buyer made a written misrepresentation as to solvency.[25] This right of reclamation is a means of self-help as long as a seller can induce a buyer to surrender the contract goods voluntarily. Where successfully utilized, reclamation bars all other remedies with respect to the reclaimed goods.[26] For example, if a Farmer within the 10-day period talks an insolvent Contractor into returning seed wheat for which the Contractor has 4 months to pay, the Farmer waives any claim for recovery of contract damages or the contract price from the Contractor. Nevertheless, this method would probably be to the Farmer's advantage because the insolvency of the Contractor might well make it impossible to collect either damages or the price from him.

A seller may be privileged to resell contract goods after breach of contract by the buyer. If the contract expressly so provides, or if the goods are of a perishable nature, or if the buyer has been in default in payment for an unreasonable time, the Sales Act permits a seller in possession of the goods to resell the contract goods to a third party free and clear, regardless of whether the property in the goods has technically passed to the buyer. If the seller makes a profit on the resale, he can keep it; but, if he suffers a loss--either because of the buyer's breach of contract or because a low price is received on resale--the seller can recover damages from the buyer.[27]

The Code expands the availability of a seller's privilege of resale. Under the Code, a seller may resell contract goods if the buyer wrongfully rejects or revokes acceptance of the goods, fails to make a payment due on or before delivery of the goods, or repudiates his contractual obligations before they are due.[28] A seller's privilege of resale is obviously a highly effective form of self-help, permitting a Farmer-seller with a vertical coordination contract to obtain ready cash for contract goods following a breach of contract without lengthy court proceedings. Furthermore, where the market price of contract goods fluctuates, as is usual with agricultural commodities, the privilege of resale allows a Farmer-seller to obtain a profit in a rising market which he would not have made if the Contractor had paid for the goods at the contract rate. The privilege of resale also allows a Farmer-seller to minimize the amount of damages owed him by the Contractor because of a falling market, thereby lessening the Farmer's dependency on the Contractor's solvency.

Buyer's Privilege of Self-Help

A buyer is not obligated to accept goods which do not conform to the contract unless he agrees to do so. Both the Sales Act and the Code permit a buyer to terminate his obligations concerning nonconforming goods by notifying the seller within a reasonable time that the buyer will not accept the goods.[29] The Code also allows a buyer to retain the goods in his possession after rightful rejection, as security for reimbursement of payments that he made or expenses that he incurred concerning the goods, and to resell the goods in a commercially reasonable manner to recoup these outlays.[30] In contrast, the Sales Act only allows a buyer to retain and resell rejected goods if the buyer cancelled the contract because of the seller's breach and the seller refused to accept the return of the goods.[31]

Both the Code and the Sales Act allow a buyer to reject the goods delivered by the seller and sue for damages, but, again, the Sales Act provision is narrower. The Code allows rejection and damages

regardless of who has title,[32] whereas the Sales Act permits the coupling of damages with rejection only if the property in the goods did not pass to the buyer.[33] Thus, where a rancher makes an unconditional contract for the sale of six identified ewes in a deliverable state and only delivers five ewes, the buyer is privileged to reject the five ewes under both the Sales Act and the Code, but he can recover damages only under the Code.

If a seller commits a material breach of contract, a buyer is privileged to withhold his own performance under both the Code and the Sales Act.[34] For example, if a Contractor fails to deliver contract inputs to a Farmer, the Farmer can simply refuse to pay the contract price. Often, a buyer's withholding of performance will be exercised as part of the privilege of cancellation of the contract, also recognized by both the Code and Sales Act. The Code allows a buyer to cancel if a seller fails to make delivery, repudiates his contractual obligations, delivers goods which the buyer rightfully rejects, or delivers goods which the buyer accepts but later justifiably refuses.[35]

In addition to allowing cancellation, the Code allows a buyer to recover compensatory damages and any of the price that has been paid.[36] The Sales Act, on the other hand, limits a buyer's privilege of cancellation to situations where the seller has broken a promise that a condition necessary to the seller's or buyer's liability would occur[37] and to situations where the seller has breached an express or implied warranty.[38] Also in contradistinction to the Code, the Sales Act does not allow a buyer both to cancel a contract and to recover compensatory damages, although the Act does permit a buyer who cancels to recover any portion of the contract price that has been paid.[39] Cancellation by a buyer is possible under both the Code and Sales Act despite receipt and acceptance of the contract goods, as long as the buyer was unaware of the failure of the goods to conform to the contract when he accepted them. A buyer who revokes acceptance and cancels must, however, promptly notify the seller of the revocation of acceptance and offer to return the goods that have been received.[40]

The Code permits a buyer to utilize another type of self-help which is generally unavailable under the Sales Act. The Code privileges, but does not require, a buyer to "cover" a breach and recover damages measured by the costs of "covering," where a seller breaches by nondelivery, repudiates in advance his contractual obligations, delivers goods that are rightfully rejected, or delivers goods which the buyer later justifiably refuses (revocation of acceptance).[41] "Covering" means the buyer's reasonable, good-faith purchase of substitutes for contract goods within a reasonable time after learning of the seller's breach.[42] Thus, if a Contractor fails to deliver fertilizer to a Farmer under a vertical coordination contract, the Farmer can buy the contract amount of fertilizer on the open market and sue the Contractor for damages to the extent that the market price exceeds the contract price. If the contract price is higher than the market price, the Farmer is entitled to whatever savings he reaps, although he cannot, of course, recover damages because he will not have suffered any.

COMPENSATORY DAMAGES

Compensatory damages for breach of contract are intended to put a nonbreaching party in as good a position as if the contract had been performed as promised. The damages are calculated at the least cost to the defendant and without charging him for damage to the nonbreaching party that the defendant had no reason to foresee when he made the contract.[43] Thus, it is often said that compensatory contract damages must be both caused by a breach of contract and foreseeable by the breaching party. In reality, however, the two requirements blend together, and foreseeability is controlling.[44] Foreseeable damages are those likely to be caused by breach. Assume, for example, that a Contractor agrees to furnish a Farmer with a special type of broiler feed, which should enable the Farmer to obtain a premium price for his broilers. If the Contractor fails to deliver the feed, the Contractor should foresee that the Farmer may have to use ordinary feed and consequently sell his broilers at less than the expected premium price. The Farmer should therefore be able to recover compensatory damages for the monetary loss that he suffers because of the Contractor's breach of contract.

A starting point in the measurement of this loss is the difference between the premium price anticipated by the Farmer, if he had used the special feed, and the price that the Farmer actually receives for his broilers. However, the difference between these prices does not necessarily reflect the monetary loss actually suffered by the Farmer because of the breach. Thus, the amount that the Farmer saves by purchasing ordinary instead of special feed should be deducted from his loss. Also, if the Farmer could have obtained the special feed elsewhere at the time that the Contractor agreed to deliver it, the Farmer will not be able to recover any damages caused by his failure to do so. Finally, if the Contractor delivered some of the special feed before breaching, the contract price for the feed received should be deducted from the Farmer's damages.

Seller's Action for Damages

Both the Code and the Sales Act recognize a seller's action for compensatory damages. The Code allows a seller to sue for damages when the buyer wrongfully rejects or revokes acceptance of goods, when he fails to make a payment due on or before delivery, or when he repudiates his contractual obligations prior to performance.[45] The Sales Act allows compensatory damages if a buyer wrongfully neglects or refuses to accept and pay for the goods.[46]

An action for compensatory damages may, but need not, be exercised in conjunction with a seller's privilege of resale, where the latter is also available.[47] If the privilege of resale is also exercised, a seller is, of course, only allowed to recover damages if he does not break even or make a profit on the resale. The damages recoverable under both the Code and Sales Act are the difference between the resale price and the contract price, plus incidental damages caused by the breach or resale, like the expense of transporting the goods back to the seller and the expense of advertising the goods for resale, minus savings attributable to the buyer's breach.[48] For example, assume that a Farmer contracts with a Contractor to deliver 50 acres of sweet corn for canning at a stated price and that, upon the Contractor's repudiation of the contract, the Farmer resells the corn to another canner at a lower price. In an action for compensatory damages against the Contractor, the Farmer can recover the difference between the contract price and the price actually received for the corn, plus any additional cost incurred in transporting the corn to the second canner. However, any expenses saved by the Contractor's breach, like the expense of delivering the corn to the Contractor's plant, if this was to be borne by the Farmer, must be deducted from this amount.

Where a seller sues for compensatory damages, without utilizing his privilege of resale, a different measure of damages is applied. The Uniform Sales Act differentiates between situations where there is and is not an available market for the regular purchase and sale of the type of goods covered by the contract. If there is an available market, the seller's damages are measured by the extent to which the contract price exceeds the price in that market at the time and place that the goods should have been accepted, or, if no time is fixed in the contract for acceptance, at the time and place of refusal to accept.[49] This procedure would be the typical measure of damages for breach of many vertical coordination contracts under the Sales Act because available markets generally exist for staple commodities bought and sold under such contracts. However, if there is no available market for contract goods, the Sales Act states that the seller can recover for all loss directly and naturally resulting from the buyer's breach.[50]

A seller's duty to minimize damages exists under both of these measures of damages, but it is important that a seller actually exercise his privilege of resale only under the no-available-market condition. The available market measure of damages is computed on the basis of an estimate of what would have happened if the seller had made a resale. Because this estimation cannot easily be made where there is no regular market readily available, a seller would be wiser in that situation to make a resale, if a buyer can be found, and have his damages computed on the basis of the difference between the contract price and the resale price. Otherwise, a court may attempt to estimate the amount the seller could have made on resale and deduct this from the loss resulting from the buyer's breach.[51] A seller's duty to minimize damages is especially important under the Sales Act if a buyer repudiates his contractual obligation to accept and pay for goods before the goods are ready for delivery. In this situation, a seller can

recover no greater damages than he would have suffered if he had done nothing toward carrying out the contract after receiving notice of the buyer's repudiation.[52]

The basic Code measure of compensatory damages is the extent to which the contract price exceeds the market price at the time and place for delivery of possession to the buyer, as specified by the contract, plus incidental damages caused by the breach, like a seller's expense in stopping delivery of the goods and returning them to his farm, less expenses saved as a result of the buyer's breach.[53] This computation method differs from the Sales Act "available market" measure of damages in several respects. In the first place, the relevant market price under the Code is the market price at the time and place where the contract requires the seller to offer delivery of the goods to the buyer, not the price prevailing at the more nebulous time and place where the buyer ought to have accepted the goods.[54] Second, a seller is clearly entitled to recover incidental damages, as well as lost profits, a right that was not as certain under the Sales Act.[55] However, the most important statutory innovations of the Code with respect to a seller's compensatory damages involve the concept of substitute markets and an alternative measure of damages that is applicable where comparison of the contract price with a relevant market price is not a fair index of the financial effect of a buyer's breach on the seller.

In regard to substitute markets, if a seller cannot establish the market price that prevailed at the time and place that he was required to offer delivery to the buyer, or if there was no such price, the Code allows a seller to utilize any market price which is a "reasonable substitute" in establishing his damages.[56] Thus, if a contract called for the delivery of soybeans to a buyer on a particular Monday afternoon in Danville, Ill., and there were no comparable sales in Danville until a week later, the Code would permit the seller to utilize the price of the soybeans at the later date in measuring his damages caused by the buyer's breach, provided that this price was a "reasonable substitute" for the market price prevailing in Danville on the delivery date.

The second innovation of the Code is to provide an alternative measure of damages where the market or substitute market measure of damages ". . .is inadequate to put the seller in as good a position as performance would have done. . . ."[57] This alternative measure of damages is the profit, including reimbursement of reasonable overhead, which a seller would have made from full performance by the buyer, plus costs reasonably incurred by the seller because of the breach, with due credit for payments made or proceeds of resale.[58] This method is especially important where the relevant market price of the contract goods equals or exceeds the contract price. Under the Sales Act, most judges assume that a seller suffered no damage in this situation, and, in fact, may have benefited from the breach by the buyer, because a price equivalent to or greater than the contract price is readily available. However, this assumption is unrealistic with respect to dealers who can obtain an unlimited supply of the contract goods for sale at a standard price. These dealers inevitably lose a profit by a buyer's breach because they could have sold an additional unit at the same price to anyone else willing to purchase the contract goods. Therefore, it is principally dealers with access to an abundant supply of standard-priced items who will be able to utilize the alternative Code damage provision.[59] Some Farmers may have sufficiently large production and standardized prices to be able to take advantage of this alternative measure of damages on the same basis as dealers. Insofar as vertical coordination contracts are concerned, however, it appears that a Contractor is more likely to qualify to recover his profit on an individual deal with a Farmer if the market price equals or exceeds the contract price.

A seller does not actually need to exercise his privilege of resale under either of the Code damage provisions because, as in the case of the available market measure of damages under the Sales Act, the measures of damages are based upon an estimate of what would have happened if the seller had exercised this privilege, and the seller's duty of mitigating damages is accordingly satisfied. Moreover, the Code allows a seller more freedom of action than the Sales Act in cases where a buyer repudiates his contractual obligations before contract goods are ready for delivery. The Sales Act, it will be recalled, places an arbitrary ceiling on the seller's damage recovery--the amount of damages the seller would have incurred if he had ceased performance when notified of the buyer's repudiation.[60] Thus, under the

Sales Act, a Farmer who continues to cultivate contract hybrid seed corn after the Contractor notifies the Farmer that he will not accept it can never recover all of his expenses in maturing the crop after notice of repudiation, if the market price exceeds the contract price at the time that the Contractor ought to have accepted the seed corn but still does not cover the Farmer's cost of production. In contrast, the Code permits a seller to recover the full damages caused by a buyer's advance repudiation of his contractual obligations as long as the seller could have reasonably believed that he would minimize his losses by completing his preparation of the contract goods.[61]

Buyer's Action for Damages

When a seller fails to deliver goods conforming to the contract at the appointed time, both the Code and the Sales Act allow a buyer to recover compensatory damages.[62] The same general distinctions exist between these Code and Sales Act provisions as between the Code and Sales Act provisions on a seller's recovery for a buyer's wrongful refusal to accept or pay for the goods. Thus, the Code specifically allows recovery for a buyer's incidental damages caused by the seller's breach, like the cost of inspecting and storing rightfully rejected goods, whereas the Sales Act does not. The Code measures damages by the difference between the contract price and the market value of the goods, without an alternative damage provision, but with the same far-reaching substitute market provision, whereas the Sales Act makes the same distinction between goods with and without an available market in computing damages.

Aside from the specific Code provision concerning incidental damages, the principal difference between the Code and Sales Act measures of damages involves the time at which the relevant market price is ascertained. The Code refers to the time at which a buyer learns of the seller's breach,[63] and the Sales Act refers primarily to the time that delivery is due under the contract.[64] The Code deliberately departs from the Sales Act rule in order to mesh a buyer's damage recovery with his privilege of cover, a privilege not generally available under the Sales Act.[65] "Cover" is the purchase of goods to substitute for those due from a breaching seller and is the rough equivalent of a seller's privilege of resale. If the privilege of cover is exercised, a buyer can recover damages from the seller for incidental expenses caused by the breach and for the extent to which the cost of covering exceeds the contract price, less any expenses saved by the breach.[66] A buyer's compensatory damages for nondelivery under the Code are determined by reference to the relevant market price at the time that the buyer learned of the seller's breach, because the privilege of cover exists at this time. If the Code had retained the Sales Act reference to the market price at the time delivery was due under the contract, the disparity between the time at which the privilege of cover could be exercised and the time at which damages would be computed might have encouraged buyers to attempt to select the remedy which promised the greatest financial rewards.[67]

Buyers customarily include in their claims for damages allegations of "consequential damages" above and beyond the loss caused by their inability to obtain the contract goods at the contract price. A typical example of consequential damage in the vertical coordination setting would be the deterioration in a Farmer's crops caused by a Contractor's failure to deliver contract goods, for example, fertilizer, pesticides, or seed, at the agreed time. Both the Sales Act and the Code are interpreted to limit recoverable consequential damages to losses that were foreseeable by the seller when the contract was made and that could not be avoided by due diligence on the part of the buyer. The Code, for example, declares that--

> Consequential damages resulting from the sellers breach include
>
> (a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise. . . .[68]

Thus, crop damage inflicted by the elements has been allowed to a farmer as consequential damages if a dealer failed to deliver farm equipment as agreed.[69] On the other hand, a farmer was not allowed to recover consequential damages for wheat loss caused by grasshoppers during a delay in harvesting occasioned by a dealer's failure to deliver a harvesting machine at the agreed time. The judge determined that the dealer had no reason to foresee a

grasshopper raid at the time he agreed to deliver the harvesting machine.[70] Of course, even though the dealer did have reason to expect an influx of grasshoppers at harvesting time, the farmer would nevertheless have been denied recovery with respect to grasshopper-caused wheat loss if he also had reason to expect a grasshopper raid and could have bought or leased another harvesting machine and harvested the crops before the grasshoppers arrived.

RESTITUTION

Restitution is a judicial remedy, usually involving the award of money damages, which seeks to put a nonbreaching party in as good a position as before the contract was made.[71] The primary difference between restitution and the form of self-help referred to as "cancellation" is that restitution involves a judicially declared and enforced cancellation of a contract. As in the case of cancellation through self-help, restitution is only available where there has been a serious and substantial breach of contract,[72] and the nonbreaching party is willing to return the value of any partial performance by the breaching party.[73] The measure of restitutionary money damages is the reasonable value of the performance completed by the nonbreaching party, regardless of the contract price, unless the contract provides that a definite sum of money is the equivalent of the performance completed. In this situation, restitutionary damages are not allowed, and the nonbreaching party can only recover the agreed money value of the performance rendered.[74]

For instance, assume that a Farmer agrees to sell 40,000 broilers to a Contractor at a stated price per bird; the birds are to be delivered in two lots of 20,000, with payment for all of the broilers to take place after delivery of the first lot. If the Contractor fails to pay for all of the chickens after delivery of the first lot, the Farmer can ask a judge to cancel the contract and award him the sum due for the broilers delivered. The Farmer cannot ask for the reasonable value of the broilers delivered because there was a definite agreement between the parties on monetary value of each broiler. On the other hand, if the price for the broilers is to be the building of a broiler house for the Farmer by the Contractor, and the Contractor fails to perform after delivery of the first lot of broilers, the Farmer can ask a judge to cancel the contract and award the Farmer the reasonable value of the contract broilers, even if this reasonable value exceeds half the value of the broiler house that the Contractor had agreed to erect.

Restitution is principally important where exercise of the privilege of cancellation is ineffectual to protect a nonbreaching party because he has partly or fully performed his contractual obligations and must recover the value of this performance from the breaching party to be in as good a position as if the contract had never been made. Restitutionary damages are generally available whenever and wherever cancellation is permitted by the Code or the Sales Act.

SPECIFIC PERFORMANCE

Specific performance is a judicial remedy for breach of contract which requires actual performance of the promises in the contract.[75] In a broad sense, the term "specific performance" could be applied to any judicial remedy which gives a party substantially the promised performance. But in its traditional meaning, the term denotes a court order that a breaching party shall do what he promised to do or shall refrain from doing what he promised not to do. Failure to obey this court order constitutes contempt of court and is punishable by fine, or imprisonment, or both.[76] Specific performance in this traditional sense is not customarily granted if money damages are adequate to redress the consequences of breach.[77] Thus, specific performance is essentially a buyer's remedy because most sales are for money and a judgment for money damages is ordinarily considered adequate, unless the contract goods are "unique."[78] If the contract goods are readily available in the market, like pesticides and fertilizer, a buyer will not be able to obtain a court order for specific performance.

In an endeavor to liberalize the availability of specific performance, the Uniform Sales Act grants the remedy to a

buyer if a judge "thinks fit" in cases where a seller breaches any contract to deliver specific or ascertained goods.[79] Nevertheless, most judges have interpreted the Sales Act in the light of prior law, and have continued to deny specific performance where contract goods are not unique.[80]

Under the Sales Act and general principles of contract law, virtually the only buyers who qualify for specific performance are those who purchase heirlooms, priceless works of art, or goods in extremely short supply. The Code therefore states, ". . .[s]pecific performance may be decreed where the goods are unique or in other proper circumstances. . ."[81] with the explanation that ". . .this Article seeks to further a more liberal attitude than some courts have shown in connection with the specific performance of contracts of sale."[82] The Official Comments to the Code describe the principal statutory innovations of the Code as (1) deletion of the requirement that goods must be specific and ascertained for specific performance to be available, and (2) addition of broad general authority to award specific performance in "proper circumstances" where goods are not literally unique; for example, where cover is not practicable.[83] The "proper circumstances" innovation is important to the parties to vertical coordination contracts. The Official Comments state that the "proper circumstances" test requires evaluation.

> [O]f the total situation which characterizes the contract. Output and requirements contracts involving a particular or peculiarly available source or market present today the typical commercial specific performance situation, as contrasted with contracts for the sale of heirlooms or priceless works of art which were usually involved in the older cases.[84]

Vertical coordination contracts often have output and requirements aspects and therefore gain an increased specific enforceability under the Code. For example, a canner-grower contract frequently encompasses the Farmer's annual output of a particular crop. Moreover, the contract crop may be subject to such rigid contract specifications concerning type, grade, quality, method of cultivation, and so on that close substitutes may not be readily available on the market, even though the goods are not literally unique in the traditional sense.

A judge ordinarily has discretion to grant or to refuse to grant an order for specific performance, even with respect to unique goods. The following are among the factors considered:

> [T]he public interest, oppression and sharp practice in the formation of the contract, inadequacy of consideration, mistake even though unilateral in character, hardship that will be caused by enforcement, the plantiff's own breach or inequitable conduct.[85]

Another important consideration, pertinent to many vertical coordination contracts, is the ease of enforcing an order of specific performance.[86] A contract which specifies the way livestock or crops are to be grown obviously raises more problems of detailed and extended supervision than, say, a contract for sale of corn already harvested. The difficulty of specifically enforcing a vertical coordination contract requiring a lengthy and closely regulated performance is obviously greatest if the Farmer breaches prior to performance of any of his contractual obligations. To the extent that partial performance precedes breach, the difficulties and duration of enforcement will be correspondingly reduced. Thus, if the Farmer does not breach until after the harvesting of contract crops or the raising of contract livestock, an order of specific performance should be readily enforceable.

Replevin

Replevin is an action at law available to a person with a right to the possession of contract goods which are being wrongfully detained by another person. In contrast to a court order for specific performance, replevin involves seizure of the disputed goods by the sheriff and their award to the prevailing party by the judge.[87] However, like a court order for specific performance, replevin is principally a buyer's remedy. A seller is not ordinarily allowed to replevy goods simply because a buyer fails to pay for them.[88] To a buyer the principal advantage of replevin over an order for specific performance is that in replevin a buyer only has to establish a right to possession of the contract goods. The goods' uniqueness is immaterial.

A buyer can replevy contract goods from a seller under the Sales Act only if the property in the goods has passed to the buyer and the seller wrongfully fails or

refuses to deliver them.[89] The Code markedly expands the availability of replevin to a buyer, permitting replevy of identified contract goods ". . .if after reasonable effort he is unable to effect cover for such goods or the circumstances reasonably indicate that such effort will be unavailing. . . ."[90] Another Code provision allows a buyer to replevy contract goods from a seller who becomes insolvent within 10 days after the seller's receipt of the first partial payment for the goods.[91] Furthermore, the Code makes replevin available to a seller in several situations in which it was unavailable under the Sales Act. Unlike the Sales Act, the Code permits a seller to cancel a contract for sale after the contract goods have been delivered to the buyer and to reclaim contract goods from an insolvent buyer within certain time limits.[92] Replevin should be available if a seller adopts either of these courses of action.[93]

Seller's Action for the Price

Basically, a seller's action for the contract price is the functional equivalent of a buyer's action for specific performance. Both remedies give the respective parties what the other party promised. A seller's action for recovery of the contract price results in an order directing the sheriff to seize and sell the buyer's property, if necessary, in order to satisfy his obligation to the seller.

The Sales Act generally allows a seller to sue for the price if the buyer has title to the goods and wrongfully refuses to pay for them.[94] If title has not passed to the buyer, a seller cannot sue the buyer for the price under the Sales Act, unless payment is due on a specific day and is not made when due, or unless the goods cannot be readily resold for a reasonable price.[95] The Code takes a different tack by restricting a seller's ability to recover the contract price to situations where a buyer fails to pay the contract price as it comes due and one of the following conditions also exists: The buyer accepts the contract goods; the contract goods are lost or destroyed after risk of loss has passed to the buyer; or the contract goods cannot be resold or are not likely to be resold "after reasonable effort to resell them at a reasonable price. . . ."[96] In the limited situations in which the Code permits a seller to sue for the price, the Code also allows the seller to recover incidental damages caused by the buyer's breach.[97] If a seller sues for and recovers the contract price from a buyer, the contract goods must be turned over to the buyer. If a seller sues for the price after being unable to resell the contract goods, but later finds a new buyer, the amount of the resale price must be deducted from the contract price to determine the amount of money that the buyer actually owes to the seller.[98]

Determination by the Parties of Remedies for Breach of Contract

The preceding sections of this chapter dealt with the remedies available to parties who have not explicitly agreed upon the consequences of breach. The absence of an explicit agreement concerning breach does not, of course, mean that the parties ignored the problem. By taking the substantive prerequisites of a remedy into consideration in drafting their contract, the parties can indirectly affect the availability of that remedy. Moreover, by deliberately setting high or low standards of performance, the parties can measurably increase or decrease the likelihood that resort to a remedy for breach of contract will be necessary. The present section focuses on the extent to which the parties can explicitly contract with respect to the consequences of breach of contract.

The Uniform Sales Act, reflecting our traditional belief in freedom of contract, places no limitations on the parties' ability to contract concerning the consequences of a breach. The result is that courts in Sales Act jurisdictions have evolved judge-made limitations on contractual modifications of remedies in order to prevent unfair and unwise results in extreme cases.[99] The Uniform Commercial Code drew on this experience in formulating general statutory standards for the permissible modification of contract remedies. These standards will undoubtedly be influenced even in States where the Code has not been adopted.

The Code allows the parties considerable leeway in modifying the remedies for breach of contract. The baseline requirements are that the modification cannot be unconscionable and an adequate remedy must be allowed to both parties to the contract.[100] An agreed remedy does not have to be a traditional remedy for breach of

contract in order to be adequate. Thus, the Code specifically acknowledges that a buyer's remedy for breach of warranty can be limited to requesting the seller to repair or replace defective goods, as long as the buyer is not precluded from also recovering consequential damages for personal injuries derived from the breach of warranty.[101] In order to insure that the parties really mean to supplant the traditional remedies for breach of contract when they specify an additional remedy, like repair of defective goods at the seller's expense, the Code provides that an additional contract remedy is optional unless the parties expressly state that the additional remedy is to be the exclusive remedy for breach of their contract.[102] Furthermore, if a contract clause which establishes an agreed exclusive or limited contract remedy fails of its essential purpose for whatever reason, the Code declares that the full panoply of remedies authorized by law become available.[103] For example, if a contract provides that a buyer's sole and exclusive remedy for a breach of a warranty of quality that does not cause personal injuries is replacement of the defective goods by the seller, and the seller's plant burns down so that he is unable to replace defective goods, a buyer who receives defective goods can pursue any of the judicial and nonjudicial remedies for breach of contract described in this chapter.

A relatively common type of agreed contract remedy is a clause stipulating the amount of damages recoverable for breach of contract. According to pre-Code law, a liquidated damage clause is valid and enforceable if (1) the amount fixed as damages is a reasonable forecast of just compensation for the harm that is caused by breach and not a penalty, and (2) the harm that is caused by the breach is very difficult to measure accurately.[104] The Code adopts a similar standard:

> Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.[105]

The following liquidated damage clause would be acceptable in both Code and Sales-Act jurisdictions:

> Seller is to be charged $5.00 per crate or box for all crates or boxes furnished by Buyer that are lost, damaged, or destroyed by any cause whatsoever. This sum is agreed upon as liquidated damages and not as a penalty to cover expenses incurred by Buyer in repairing, replacing, recovering, or attempting to recover lost, damaged, or destroyed crates or boxes. The sum represents a reasonable forecast jointly made by Seller and Buyer of the probable actual loss Buyer will suffer from Seller's failure to return Buyer's crates and boxes in good condition as agreed.[106]

The Code provides that if a buyer breaches a contract after paying in advance for goods not yet delivered, the seller may deduct validly agreed upon liquidated damages from any refund or restitutionary damages paid to the buyer.[107] In the absence of a liquidated damage provision, the Code authorizes the seller to deduct 20 percent of the value of the buyer's total performance or $500, whichever is smaller, from any refund or restitutionary damages.[108] This latter Code section is, in effect, a statutory forfeiture provision. A seller does not have to prove any loss to recover the prescribed amount. However, if his actual losses from breach are greater than this amount, he can prove them and recover compensatory damages.[109]

Another type of agreed remedy, often found in contracts by agricultural cooperatives, is a clause providing for an order of specific performance in the event of a breach.[110] These clauses do not, of course, destroy a judge's discretion in determining whether to order specific performance, but the existence of such clauses may properly influence the exercise of that discretion.[111] These clauses may, for instance, indicate the parties' belief that money damages constitute an inadequate remedy.

The final agreed remedy to be discussed is a provision for settling contract disputes by arbitration. A decision of the chosen arbitrators, called an award, will be enforced by the courts, provided that the arbitrators hold a fair hearing and act within the scope of the arbitration clause.[112] However, at common law, an arbitration agreement relating to all future disputes is void; an arbitration clause does not generally make arbitration a condition precedent to a legal action for breach of contract; and nominal damages are

frequently all that can be obtained for breach of an arbitration clause.[113] These common-law rules, which more or less emasculate arbitration as a significant agreed remedy for breach of contract, are not dealt with by either the Sales Act or the Code. Most States have an arbitration statute which makes arbitration agreements that conform to certain formalities specifically enforceable. Under these statutes, such agreements are grounds for staying judicial proceedings concerning the same subject matter.[114] Some arbitration statutes expressly validate agreements to arbitrate all future disputes.[115]

FOOTNOTES--CHAPTER 8

[1] 5 Corbin, Contracts § 990 (1964) [hereinafter cited as Corbin].

[2] See 6 Corbin § 1253.

[3] 5 Corbin § 992.

[4] Id. § 1102.

[5] Id. § 990.

[6] 6 Corbin § 1253.

[7] Uniform Sales Act § 53(1)(a), (2) [hereinafter cited as U.S.A.].

[8] Uniform Commercial Code § 2-703(a) [hereinafter cited as U.C.C.].

[9] See 6 Corbin § 1253.

[10] U.S.A. § 54(1).

[11] U.C.C. §§ 2-703, 2-702(1).

[12] Vold, Sales § 51 (2d ed. 1959) [hereinafter cited as Vold].

[13] U.S.A. §§ 57, 76(3).

[14] U.C.C. §§ 2-705, 1-201(23).

[15] U.C.C. § 2-705.

[16] U.S.A. § 57, U.C.C. § 2-705, Comment 6.

[17] The Sales Act refers to "rescission" of a contract for sale. This is a technical legal term for cancellation of the contract.

[18] U.S.A. § 61.

[19] U.S.A. § 65.

[20] Note, 49 Ky. L.J. 240, 274 (1960).

[21] U.S.A. § 61(1).

[22] U.C.C. § 2-703 and Comment 1.

[23] U.S.A. §§ 61, 65.

[24] U.C.C. § 2-703; see Note, 49 Ky. L.J. 240, 283, n. 83 (1960).

[25] U.C.C. § 2-702(2).

[26] Id. § 2-702(3).

[27] U.S.A. § 60(1).

[28] U.C.C. § 2-703(d).

[29] U.S.A. § 50; U.C.C. § 2-602(1) and (2).

[30] U.C.C. § 2-711(3).

[31] U.S.A. § 69(5).

[32] U.C.C. § 2-711(1).

[33] U.S.A. § 69(1)(c).

[34] U.S.A. § 11; U.C.C. § 2-711.

[35] U.C.C. § 2-711(1).

[36] Ibid.

[37] For example, where a seller fails to immunize contract cattle from hoof and mouth disease despite a promise to do so and the buyer refuses to accept and pay for the cattle unless they are immunized.

[38] U.S.A. §§ 11, 69; see chapter 5 for discussion of warranties.

[39] U.S.A. § 69(1)(d), (2).

[40] U.S.A. § 69(3); U.C.C. § 2-608.

[41] U.C.C. §§ 2-711, 2-712.

[42] U.C.C. § 2-712(1).

[43] 5 Corbin § 1002.

[44] Id. §§ 1006, 1007, 1114.

[45] U.C.C. § 2-703(d) and (e).

[46] U.S.A. § 64.

[47] See text accompanying U.S.A. § 64 for discussion of a seller's privilege of resale.

[48] U.S.A. § 60(1); U.C.C. § 2-706(1).

[49] U.S.A. § 64(3).

[50] U.S.A. § 64(2).

[51] Note, 49 Ky. L.J. 270, 278 (1960).

[52] U.S.A. § 64(4).

[53] U.C.C. § 2-708(1).

[54] Compare U.S.A. § 64(3) with U.C.C. § 2-708(1).

[55] Vold § 36, at 216.

[56] U.C.C. § 2-723(2).

[57] U.C.C. § 2-708(2).

[58] Ibid.

[59] Hawkland, Sales and Bulk Sales 153-54 (1958).

[60] U.S.A. § 64(4).

[61] U.C.C. § 2-704(2).

[62] U.S.A. § 67; U.C.C. § 2-713. Section 67 of the Uniform Sales Act is literally limited to situations where the buyer does not have property in the goods, but the same general principles are applied if the buyer sues for breach of contract after the property is passed to him. 3 Williston, Sales § 596(rev. ed. 1948).

[63] U.C.C. § 2-713(1).

[64] U.S.A. § 67(3).

[65] Hawkland, Sales and Bulk Sales 135-36 (1958).

[66] U.C.C. § 2-712(2).

[67] Hawkland, Sales and Bulk Sales 136 (1958).

[68] U.C.C. § 2-715(2)(a); see also 5 Corbin §§ 1008, 1009.

[69] McCormick, Damages 671 & n. 47 (1935).

[70] Ibid.

[71] 5 Corbin § 996.

[72] Id. § 1104.

[73] Id. § 1114.

[74] Id. §§ 1110, 1112.

[75] Id. § 990, at 3.

[76] 5A Corbin § 1138.

[77] Id. § 1139.
[78] Id. § 1146.
[79] U.S.A. § 68.
[80] Hawkland, Sales and Bulk Sales 143-44 (1958).
[81] U.C.C. § 2-716(1).
[82] U.C.C. § 2-716, Comment 1.
[83] Id. at Comment 2.
[84] Ibid.
[85] 5A Corbin § 1136, at 96. E.g., Campbell Soup Co. v. Wentz, 172 F. 2d 80 (3d Cir. 1948) (refusing specific performance because contract was unconscionable).
[86] 5A Corbin § 1171.
[87] Delaney, Is the Losing Defendant in Replevin Privileged To Retain the Chattel and Pay Its Value? 13 N.Y.U. Intra. L. Rev. 212-13 (1958).
[88] Whitney, Law of Modern Commercial Practices § 412 (1958).
[89] U.S.A. § 66.
[90] U.C.C. § 2-716(3).
[91] U.C.C. § 2-502(1). See U.C.C. § 1-201(23) for the definition of "insolvency."
[92] Note, 49 Ky. L.J. 270, 275-76 (1960).
[93] Peters, Remedies for Breach of Contracts Relating to the Sale of Goods Under the Uniform Commercial Code: A Roadmap for Article Two, 73 Yale L.J. 199, 218-19 (1963).
[94] U.S.A. § 63(1).
[95] U.S.A. § 63(2)-(3).
[96] U.C.C. § 2-709(1).
[97] Ibid. Incidental damages are defined in U.C.C. § 2-710.
[98] E.g., U.C.C. § 2-709(2).
[99] E.g., Limitations on Freedom to Modify Contract Remedies, 72 Yale L.J. 723 (1963).
[100] U.C.C. §§ 2-302, 2-719 and Comment 1.
[101] U.C.C. § 2-719(1)(a), (3).
[102] U.C.C. § 2-719(1)(b).
[103] U.C.C. § 2-719(2).
[104] Restatement, Contracts § 339(1) (1932).
[105] U.C.C. § 2-718(1).
[106] Cf. 2 Hawkland, A Transactional Guide to the Uniform Commercial Code, 951 (1964).
[107] U.C.C. § 2-718(3).
[108] U.S.C. § 2-718(2)(b).
[109] 1 Hawkland, A Transaction Guide to the Uniform Commercial Code, 173 (1964).
[110] Macheil, Power of Contract and Agreed Remedies, 47 Cornel L.Q. 495, 521, n. 88 (1962).
[111] Id. at 522-23.
[112] 6A Corbin § 1439.
[113] Id. §§ 1433, 1435, 1440.
[114] Id. §§ 1435, 1440.
[115] Id. § 1441.

CHAPTER 9. SECURITY INTERESTS

Vertical coordination contracts contain many types of provisions designed to give one of the parties a security interest in either inputs or outputs, or both. From the Contractor's viewpoint, a security interest may be used to protect inputs supplied by him during the production phase and to assure delivery of the final product according to contract provisions. The Farmer is basically interested in a secured transaction as a means of obtaining credit needed to perform under the contract, but he may also be interested in establishing a security interest in the commodity when it is delivered to the Contractor. The major emphasis on security interests in the vertical coordination contracts studied related to the subject-matter input--assuring that the Farmer would pay for it, that he would not permit it to become encumbered to a third party during production, and that the final product resulting from it would be delivered only to the Contractor. The establishment and maintenance of a security interest in the commodity are important provisions in many vertical coordination contracts. Such provisions interest not only the Contractor and the Farmer but also third parties.

THE NATURE OF A SECURITY INTEREST

Under the Uniform Commercial Code, a security interest is ". . . an interest in personal property or fixtures which secures payment or performance of an obligation."[1] A security interest normally arises in relation to a debt created through a credit sale or loan agreement, but it might arise to guarantee performance of an obligation, as under a vertical coordination contract. In order for the creditor to have some claim or right against specific goods of the debtor in the event of default of payment or performance, the buyer or borrower is required to put up collateral to secure the debt or to guarantee fulfillment of the contract. The creditor or secured party may take possession of the collateral, but in most cases his security interest is likely to be documentary in nature. That is, until the contract is performed, the secured party will have some document, such as a chattel mortgage or simply a provision in a vertical coordination contract, that gives him a security interest or right in the goods, but the buyer or borrower will actually possess and use the goods.

Protection against nonpayment of the debt is the most obvious reason for a creditor's desire to obtain a security interest in collateral. Of course, the parties usually intend that the underlying obligation will be met as agreed, and it is only through unforeseen circumstances that the secured party will have to look to the collateral as satisfaction for repayment. If the indebted buyer or borrower, however, fails to make payment or repayment, the creditor has the right to realize on the collateral in satisfaction of the debt.[2] Depending upon the type of security interest, the creditor may take possession of the collateral, sell it, and apply the proceeds to satisfy his claim, or he may keep the collateral as his own.[3] In the event of default, other creditors also may be seeking recovery of claims against the indebted buyer or borrower. The important advantage of being a secured creditor in such a situation is that the secured party will have his claim satisfied, to the extent of the security interest, before unsecured creditors can use the secured property to satisfy their claims.[4] In addition, to the extent that the secured creditor's claim is unsatisfied by his security interest, he will become an unsecured creditor and share in the distribution from the debtor's other assets with the unsecured creditors. Thus, even when the security interest will not satisfy the entire claim, the secured creditor will be at an advantage over unsecured creditors.

In a vertical coordination contract, the primary interest of the Contractor may be

to assure performance of the Farmer's obligation to grow, prepare for market, and deliver the crop or livestock contracted for. Fulfillment of the contract obligation may be safeguarded by the Contractor's taking a security interest in the desired product. The Contractor, for example, may sell seed, fertilizer, pesticides, and so on to the Farmer on credit and secure the purchase price of the inputs with a security interest in the crop itself. If the Farmer fails to perform according to the terms of the contract, the Contractor may have the additional right to declare a default and to take possession of the growing crop. Thus, the right of the secured party to take possession of the collateral may give him some extra control over the manner of performance under the contract. A security device may be used, likewise, to protect an interest in livestock.

Creating a Security Interest Under the Uniform Commercial Code

Since the definition of a security interest is established, as well as its desirability in a vertical coordination contract, attention may now turn to the creation of a security interest. The Code requires three steps to create an enforceable security interest: the making of a binding security agreement by the parties; the giving of value by the secured party; and the acquiring of rights in the collateral by the debtor.[5] A fourth step, perfection of the security interest, generally requires public notice of the security arrangement. Perfection usually makes the security interest enforceable against subsequent lien creditors.[6] Problems associated with perfection are discussed in subsequent sections of this chapter.

MAKING A BINDING AGREEMENT BETWEEN THE PARTIES

The required "security agreement" is merely an agreement by the parties that creates or provides for a security interest.[7] The creation of a security interest may be made previous to the required giving of value and acquiring of rights in the collateral.[8] A security agreement may also be inferred from past conduct of the parties, such as the practice of a buyer in purchasing goods on a conditional sale agreement.[9] The agreement may provide for continuing security arrangements; that is, one security agreement can fulfill the requirement for creation of many security interests.

There are no requirements for the security agreement, other than that it be an agreement to create a security interest, presently or in the future. An agreement may provide for the creation of a security interest in various types of collateral, including some or all of the personal property collateral owned or to be acquired by the debtor.[10] Except for a 1-year limitation on crops and a 10-day limitation on consumer goods,[11] the agreement may cover all present and future personal property assets of the debtor. Of course, in order to be enforceable, even against the debtor, the agreement must meet the requirements of the statute of frauds.[12] In addition, it cannot violate non-Code regulations, such as a prohibition against usury.[13]

GIVING OF VALUE BY THE SECURED PARTY

Under the Uniform Commercial Code, some value must be given to the debtor by the secured party in order to create a security interest.[14] A secured party under the Code gives value for rights if he acquires them in return for a binding commitment to extend credit, or for the extension of immediately available credit, as security for a pre-existing claim; or generally, in return for any performance or consideration sufficient to support a simple contract.[15] Thus, the requirement of giving value is rather easily met in most vertical coordination contracts.

While it is clear that one security agreement may provide for the creation of more than one security interest in different items of collateral, it is not clear whether each giving of value creates a separate security interest, or whether the first giving of value creates an interest that expands or contracts as either the obligation to perform,

the amount of debt, or the collateral changes.[16] One respected legal writer has suggested that each giving of value creates a separate security interest.[17] This principle is important in considering the priorities of conflicting interests where another creditor has acquired an interest in the collateral after the first giving of value but before the second giving of value.

ACQUIRING RIGHTS IN THE COLLATERAL

Even if there is a valid security agreement with the debtor given value, the secured party must acquire rights in the collateral before a security interest is created.[18] Apparently, these rights may be of any nature, although specific provision is made for crops and the young of livestock. For purposes of determining whether a debtor has acquired a right in the collateral, he is deemed to have no rights in crops until they are planted or otherwise become growing crops and no rights in the young of livestock until they are conceived.[19] But though future crops or young of livestock cannot become collateral for a security interest until planted or conceived, they may become collateral under the after-acquired property clause of a valid, existing security agreement without the execution of a new security instrument. The Contractor, under a vertical coordination contract, of course, may create a security interest in the unplanted seed or the breeding animals, and this interest may continue uninterrupted throughout the contract period.

The Uniform Commercial Code provides for only one type of secured transaction--the "security interest." The term "security interest" includes all consensual security interests, whether oral or written, that may be created in personal property and fixtures. Nonconsensual security interests, that is, liens that arise by operation of law, and not through the consent or agreement of the parties, are not regulated by the Code. These nonconsensual liens may be conferred by statute or by common law. The most important nonconsensual liens are the attachment lien, the execution lien, and the many statutory liens. Nonconsensual security interests, obviously, are not found in vertical coordination contracts.

TYPES OF CONSENSUAL SECURITY INTERESTS

The single term "security interest" is used in the Code to assure uniformity of treatment of such diverse consensual security arrangements as pledges, chattel mortgages, conditional sales, and liens or leases intended as security.[20] The Code, however, does not outlaw, nor is it likely to discourage, the use of these traditional security devices. An examination of the most important of these seems appropriate, because they are obviously important in non-Code States and their use is likely to continue in Code States.

The consensual liens most likely to be used in the vertical coordination contract are the chattel mortgage, conditional sale, and lease-sale. These security devices derive from the common law possessory lien called a pledge. A pledge is the transfer of possession of personal property or other security from the debtor to the creditor, as collateral security for a loan or other debt.[21] In the event of default, the creditor can sell the collateral and apply the proceeds to the debt.[22] The sole purpose of the transfer is to secure the debt. The pledge has the disadvantage of taking possession away from the debtor, who otherwise might be able to use the property productively and so decrease the possibility of default. Pledges are not generally suited for vertical coordination transactions,[23] since the Farmer's possession of the crop or livestock is essential in the production process.

The chattel mortgages is a device often used to secure a debt when the Farmer's possession of the collateral is required, as in vertical coordination contracts. In the chattel mortgage transaction, possession is given to the Farmer, but he gives the Contractor a mortgage creating a lien on the collateral.[24] If the Farmer-debtor defaults, the lien gives the Contractor-creditor the right to immediate possession of the collateral for purposes of selling it, perhaps after completing the production process, to satisfy his debt.[25] The sale procedure is regulated by statute in most States not under the Code.

The conditional sale is similar in principle to a chattel mortgage but is limited to transactions in which the debtor and creditor are at the same time a buyer and seller, as in many vertical coordination contracts. In the ordinary cash sale, the seller transfers possession and title to the buyer at time of sale. If, however, the seller is extending credit to the buyer, he may wish to secure the payment of all or part of the purchase price by retaining a security interest in the goods sold. He may do this by retaining title to the goods until the final payment is made. Such a security interest is known as a conditional sale.[26] While the debt remains unpaid, the seller-creditor retains the right to repossess the goods on default and to treat them as his own.[27] He may have added rights under vertical coordination contracts, for example, to finish growing the crops or livestock and to prepare them for market. While either the chattel mortgage or conditional sale may be used in a loan between a buyer and a seller, consideration of local law may make one preferable to the other, even though they are treated the same under the provisions of the Uniform Commercial Code.[28]

A security interest may be created also by a lease-sale arrangement.[29] In a lease-sale, the goods are leased to the prospective buyer rather than sold to him. Generally, lease payments are substantially equivalent or actually equal to typical installment-sale payments on the same goods. In addition, the contract provides that the lessee will get title to the goods at the end of the lease term or upon exercise of an option to buy, the lease payments being applied to the purchase price.[30] Thus, the practical effect is much the same as in the conditional sale: legal title is held by the creditor to secure payment of the price of the goods, and the title is transferred to the debtor upon full payment. The principal difference between the conditional sale and the lease-sale is that in the latter the lessee-buyer is not obligated to complete the purchase, but may do so at his option.

Summarizing, chattel mortgages, conditional sales, and lease-sales have the common characteristic of allowing the debtor to have possession of the collateral. The infrequently used pledge, on the other hand, requires that the creditor possess the collateral. While a chattel mortgage may be applied to any collateral, the conditional sale and the lease-sale are limited to situations where the goods constituting the collateral are acquired through the extension of credit. In the conditional sale, transfer of legal title is conditioned upon full payment of the purchase price, while a lease-sale is a rental of the goods until such time as the rental payments equal the purchase price or the lessee pays the price, at which time a sale and transfer of title may be effected.

Under some vertical coordination contracts, as in a contract for producing hybrid seed corn, for example, the subject-matter input (parent seed), the growing corn crop, and the product therefrom (hybrid seed corn) remain the property of the Contractor, and at no time does the title thereto or any part of it pass to the Farmer or any person other than the Contractor. No security interest is created; it is, rather, a type of bailment under which the Farmer's objective is not to acquire permanent property rights in the goods but to use them for a specific purpose. Relationships of this type created by vertical coordination contracts are discussed in chapter 10.

RIGHTS OF THE PARTIES

In the creation of a security interest in certain goods, consideration should be given to the rights and duties of the parties--the debtor and the secured party--with respect to each other and to the goods. These rights and duties naturally divide into those that exist prior to default and those that come into play in the event of default.

Rights and Duties Before Default

Possession and Use of the Collateral by the Debtor

The debtor is, of course, the owner of the collateral. While certain acts, such as selling or encumbering the collateral, may be a violation of the security agreement and constitute a default, the fact that

there is a security interest in the goods does not take away certain of the debtor's rights of ownership. In this respect, the Uniform Commercial Code provides that the debtor's rights in the collateral may be transferred voluntarily or involuntarily, even though the security agreement prohibits transfer or makes it a default.[31] Voluntary transfer may include the sale of the collateral or creation of another security interest in the collateral. Judicial attachments, levies, and garnishments are examples of involuntary transfers.[32]

The right of transfer under the Code differs from the right in some non-Code jurisdictions, where the law holds that restrictions on the debtor's interest, particularly when the secured party is deemed to hold legal title as in a conditional sale, can prevent the debtor's transfer of his interest in the collateral.[33] Under such a rule, other creditors cannot proceed against the debtor's interest, even by judicial attachment or levy.[34]

The Uniform Commercial Code further provides that the debtor may ". . .use, commingle or dispose of all or part of the collateral. . ." in his possession without invalidating the security interest of the secured party.[35] While the debtor's use or disposition of the goods may violate the terms of a security agreement and thus cause a default, his action does not invalidate the security interest, whether he acts with or without permission of the secured party. This provision is contrary to the pre-Code law in many States. The drafters of the Code intended to repeal the rule developed in the well-known case of Benedict v. Ratner,[36] and similar cases, that held some security interests void because the secured party gave the debtor unfettered dominion or control over the collateral.[37] The Code provision thus gives the parties more freedom in agreeing what use the debtor can make of the collateral.

The effect of permitting the secured party to allow the debtor to exercise unlimited dominion or control over the collateral goods is to facilitate the use of the "floating charge" or "lien on a shifting stock."[38] When considered in conjunction with the possibility of creating a present security interest in property yet to be acquired, the floating charge allows more freedom in substituting one chattel for another as collateral.

The Code also makes clear that a secured party's failure to require an accounting by the debtor of the proceeds of the sale of collateral, or the replacement or substitution of collateral, does not invalidate the security interest.[39] This provision, too, gives the parties more freedom in drawing up their security agreement.

The Uniform Commercial Code also provides a procedure by which the debtor may obtain from the secured party a statement of the amount due on the obligation and, in some cases, a statement of the collateral.[40] This section of the Code provides that when the debtor submits a statement of indebtedness for approval or correction, the secured creditor must comply with that request within 2 weeks. A failure to so comply will render the secured party liable for any loss caused to the debtor because of the failure to comply.[41] Similarly, if he has records that identify the collateral, the secured party must comply with a request to approve or correct a list of collateral.[42] If the secured party, however, claims a security interest in all of a particular type of collateral owned by the debtor, he need not approve or correct the list submitted by the debtor, but need only indicate that he claims such a total interest.[43]

A failure to comply with these requests for approval or correction may affect the amount of security interest that the secured party can claim against a third party. This is so if the debtor's request includes a good-faith statement of the obligation or list of collateral. If the secured party does not comply with the request, he can claim, against persons who have been misled by his failure, only a security interest as shown in the debtor's statements.[44] If the secured party no longer has an interest in the obligation or collateral when the request is received, he must notify the debtor of any successor in interest or be liable to the debtor for loss caused thereby.[45]

Inspection and Control of the Collateral by the Secured Party

One right of the secured party is the right of entry, which is not necessarily related directly to the security agreement. A right of entry may exist in the context of a vertical coordination contract even though no security interest is created. To assure that the marketable commodity meets quality standards, some vertical coordination contracts give the Contractor or his agent a right of entry to the Farmer's

premises to inspect and even control, to some extent, the production process. Such a provision is common in canner-grower contracts where special kinds of peas, carrots, beets, and so on are desired, and the Contractor exercises a detailed watch over the production process to insure a quality product.

The Contractor's right to assume management control is implicit in the right to enter the Farmer's premises and remove the product or take over the production if any of the contract provisions are not being observed by the Farmer. The right is normally exercisable in vertical coordination contracts if the Farmer fails in the proper care of the crop or animals, or if he wrongfully encumbers the contract property (inputs or marketable commodity) during the production phase. A clause in the contract usually frees the Contractor from liability for entering the Farmer's premises, finishing production of the product, and removing or harvesting it. Such a provision will often specifically release the Farmer's interest in the commodity and waive the Farmer's rights against the Contractor for trespass or damages to his premises.

Despite the fact that the person in possession of either the land or goods gives his consent to repossession, inspection, or removal of the commodity from the land, the Contractor cannot use physical force to perform such acts.[46] If the Contractor or his agent uses physical force to enter the premises and damages the premises or physically injures the Farmer, the Contractor will be liable to the Farmer for the damages. The Farmer's refusal to allow the Contractor to enter the premises, however, is a breach of the contract that enables the Contractor to recover from the Farmer any damages incurred thereby.

Possession and Use of the Collateral by the Secured Party

If the secured party is in possession of the collateral, he has a duty to use reasonable care in its custody and preservation.[47] What constitutes reasonable care may be agreed upon by the parties[48] and may include notifying the debtor-owner of any action which must be taken in respect to the collateral.[49] If the secured party himself takes action, his reasonable expenses may be added to the secured debt.[50] The secured party also has the duty to keep identifiable the collateral in his possession.[51] If the goods are in no way unique, however, he is allowed to commingle them with goods of like kind and quality.[52]

In the absence of an agreement to the contrary, the secured party may hold any increase in the collateral in his possession as additional collateral, but he must reduce the debt by any amount of money received as a consequence of holding the collateral.[53] The secured party may also repledge the collateral, so long as the terms of the repledge do not impair the debtor's right to redeem it.[54] Finally, under certain conditions, the secured party may use or operate the collateral.[55] Such use or operation is allowed (1) when it is necessary to preserve the collateral or its value, (2) when the security agreement so provides, or (3) when a court order so directs.[56] The security agreement, however, cannot authorize the use or operation of consumer goods.[57]

Regarding the risk of loss to the collateral while in the possession of the secured party, the Uniform Commercial Code provides that the risk of accidental loss or damage shall be on the debtor, unless there is agreement to the contrary.[58] The secured party is, however, liable for any loss caused by his failure to meet any of the above-mentioned obligations.[59] In such a case, he would not lose his security interest.[60]

Rights and Duties After Default

Rights and Duties of the Secured Party

On default by the debtor, the secured party generally has the right to take possession of the collateral and keep it or sell it, retaining the proceeds in satisfaction of his claim, or he may follow the procedures contained in the security agreement. These rights attach regardless of the form taken by the security interests, but they are limited in several ways, depending on the kind of obligation secured, the type of collateral, and the security agreement between the parties. Whether the secured party has possession of the collateral is of little consequence. The act of default usually gives him a right to possession,[61] if he is not already in possession. The secured party may take possession after default by judicial process or without judicial help if it may be done without a breach of the peace.[62]

The provisions of the Code are not applicable to real property collateral.[63] Therefore, if the collateral consists of both personal property and real property, the secured party may proceed against the realty in accordance with his rights under local law, or he may proceed against the personalty as provided in the Uniform Commercial Code.[64]

In case of default by the debtor, three general remedies are available to the secured creditor. First, if the collateral is not in possession of either the debtor or the secured party, the secured party may notify the holder of the collateral to make payment of the debt and may proceed to collect the debt from the holder in a commercially reasonable manner.[65] If such a collection is made to satisfy a security interest and not on a sale of accounts, contract right, or chattel paper, the secured party is entitled only to an amount which equals the debt plus reasonable expenses for collection.[66] Any excess collection must be paid to the debtor.[67]

Second, the secured party may sell, lease, or otherwise dispose of the collateral.[68] The proceeds from such disposition are applied to cover the expenses of retaking, holding, and selling the collateral, plus reasonable fees and legal expenses.[69] The remainder of the proceeds are applied first to cover the indebtedness under which the disposition was made and then to satisfy the indebtedness of any other party secured by the collateral, provided the secured party has notice of this indebtedness.[70] The secured party must account to the debtor for any surplus in proceeds over the amount of the debts secured.[71]

Unless the collateral is perishable or will decline rapidly in value, the secured party must give notice to the debtor, and any other person whom the secured party knows has a security interest in the collateral, of the intended disposition or sale, public or private.[72] Such notice must include the time and place of any public sale, or the time after which a private sale is to be made.[73] The secured party may buy the collateral himself at a public sale. He may also buy at a private sale if the collateral is of a type which is subject to widely distributed standard price quotations.[74] The purchaser of the collateral at a private or public sale takes title to the goods free of any lien or security interest if he buys in good faith and has no knowledge of defects in the sale.[75]

Third, the secured party may keep the collateral as his own in satisfaction of the obligation secured (1) when the debtor's interest in the consumer goods is less than 60 percent of the cash price or loan, and (2) when any collateral other than the consumer goods is in the possession of the secured party.[76] If the debtor or other person with a security interest does not object in writing within 30 days of receipt of this notice of intent, or if any other unnotified secured party does not object within 30 days after the secured party takes possession, the secured party may retain the collateral as his own.[77] If objection is filed within the prescribed time period, the secured party must dispose of the collateral as provided above.[78]

Rights of the Debtor

In the absence of written provisions to the contrary, made after default, the debtor has a right to redeem the collateral by making tender of full payment of the obligations secured by the collateral.[79] The tender of full payment must be accompanied by compensation for reasonable expenses incurred by the secured party in taking possession, holding, and preparing the collateral for sale, plus reasonable fees and legal expenses.[80] This right of redemption is not available to the debtor, however, after the secured party has disposed of the collateral or claimed it as his own without proper objection, as provided above.[81] This right of redemption cannot be waived except by a written agreement after default.[82]

In order to prevent the secured party from taking undue advantage of the debtor after a default, certain other rights are guaranteed the debtor, notwithstanding contrary provisions in the security agreement.[83] The first of these guaranteed safeguards for the debtor is the right to the surplus proceeds received by the secured party on disposition of collateral securing an indebtedness.[84] The right to surplus proceeds also applies in circumstances of collection of collateral by the secured party[85]--only enough of the collateral may be taken to satisfy the debt. The debtor also has a second right--the right to receive notice of an intended public or private sale of the collateral by the secured party,[86] or to receive notice

of the secured party's intention to keep the collateral in satisfaction of the secured obligation.[87]

The debtor also has, under the Code, the right to recover from the secured party any loss occasioned by the secured party's failure to comply with the Code's enforcement provisions.[88] More important than the debtor's right to damages is the right to restrain by court order any intended action of the secured party which is not in accordance with the Code's enforcement provisions.[89] Such a court order may not only prevent the secured party from taking unreasonable action, but may also provide that he proceed to sell or dispose of the goods in a specified manner.[90]

PERFECTING THE SECURITY INTEREST

Priority Over Third Parties

The most important aspect of a security interest is the protection it gives the secured party from any claims to the collateral by persons other than the debtor. This protection, often described in terms of the priority of the secured party, is particularly relevant in vertical coordination contracts where security interests are applicable. Priority refers to the arrangement of creditors or purchasers claiming conflicting interests in the collateral in the order in which the law will recognize their claims. The secured party seeks to obtain a security interest that will be accorded the highest priority if conflicting claims arise; that is, to assure that his claim will be the first one satisfied out of the collateral. For example, if the Contractor perfects his conditional sale agreement on cattle sold to the Farmer, he will be protected against--that is, take priority over--a later chattel mortgage on the same cattle given by the Farmer to a feed dealer to secure payment for feed purchased on credit. If the Farmer defaults on both debts, the Contractor with the conditional sale agreement will have first call on the cattle to satisfy his claim.

In order to obtain a priority over other claimants to the collateral, the secured party must "perfect" his security interest. In this context, perfection of a security interest means giving adequate public notice of its existence. Generally, a security interest may be perfected either through taking or retaining possession of the collateral by the secured party, or the retention of the collateral by someone holding on his behalf, or, if the debtor retains possession of the collateral, by filing notice of the security interest in the appropriate public office.

The theory behind perfection requirements is that the interest in the collateral acquired first in time should have priority over interests acquired later, if the prior interest was reasonably discoverable by those acquiring the later interests. A security interest evidenced by such public filing is reasonably discoverable. One who acquires an interest in the collateral knowing that another already has a security interest in it should expect to take a secondary position; one who acquires his interest without notice of an earlier interest is entitled to realize his expectation of obtaining first priority. Thus, the matter of priorities usually comes down to a question of when a security interest was perfected in relation to other conflicting interests.

Effect of Unperfected Interest

As a general proposition, under the Commercial Code an unperfected security interest in itself provides very little protection against any type of conflicting claim to the collateral. Between two unperfected security interests, however, the interest that first attached takes priority.[91]

The unperfected interest is subordinate to any perfected security interest, apparently without regard to whether the holder of the perfected interest knew of the unperfected interest.[92] For example, if the Contractor failed to perfect the conditional sale contract under which he sold the Farmer cattle, a chattel mortgage on the cattle subsequently taken by a bank and perfected would take priority, even though the bank knew of the contract.

The interest of a lien creditor, on the other hand, is prior to the unperfected interest only if at the time he obtained his lien he was without knowledge of the Contractor's security interest.[93] A lien creditor is one who obtains a lien on the collateral by attachment, levy, or like process.[94] In addition, a purchaser not in

the ordinary course of business who gives value without knowledge of the security interest will take the collateral free of the security interest.[95] For example, a neighbor who buys a tractor that the seller-farmer acquired on an unperfected conditional sales contract will obtain it free of the security interest if he does not know of the interest. The above provision implies that a buyer in the ordinary course of business will defeat the security interest if he is without knowledge of it and pays value. This would have been the case in most States prior to enactment of the Code, and the Code does not specifically provide otherwise.[96]

The results of failure to perfect a security interest in States not having the Uniform Commercial Code may be stated somewhat more simply. Except in the few States where a conditional sale contract need not be recorded, other secured creditors and lien creditors will have priorities if they acquired their subsequent interest for value and without notice. Likewise, a purchaser of collateral will take free of any unperfected security interest of which he is without knowledge at the time of purchase.

How To Perfect a Security Interest

Perfecting a security interest by giving notice through taking or retaining possession of the collateral would be of little use to the secured party in a typical vertical coordination contract.[97] Normally, the concern for perfecting a security interest arises when the collateral is in possession of the Farmer, so questions relating to perfection through filing notice of the security interest are most relevant.

The Uniform Commercial Code permits the secured party to perfect his interest, once it has attached, by filing a "financing statement" of one of two types in a designated public office, usually in the county court house.[98] He may file the original security agreement entered into by the parties. This kind of filing is identical to that authorized by most States for filing chattel mortgages or conditional sale contracts. Both the debt and the collateral are described in some detail. However, the Code has eliminated some of the formality formerly associated with filing of this type, particularly a collateral controlled by title certificate laws.

The Code also permits the filing of an abbreviated statement that provides little more than skeletal information about the security interest involved. Under this so-called "notice filing," all that need be filed is a statement that the debtor has given or will give a security interest in assets of a designated type which he now owns or may acquire in the future.[99] The theory behind this type of filing is that it is necessary to put on record only the information essential to permit an interested party to discover where to inquire concerning the status of the collateral.

Under the Code, it is possible to comply with the filing requirements and still not have a perfected security interest because the interest has not attached. As explained earlier, for attachment of the security interest, the agreement must be enforceable, the secured party must give value, and the debtor must have or acquire an interest in the collateral. The security interest is not perfected until all requirements for attachment are met, regardless of when filing takes place.[100] For example, if the Contractor and Farmer enter an agreement stating that any credit extended to the Farmer for the purchase of feed will be secured by certain cattle owned by the Farmer, and the Contractor files this agreement, the Contractor does not have a perfected security interest until he actually extends the credit.

In non-Commercial Code jurisdictions, it is generally necessary to record the document creating the security interest to perfect the interest against third parties. All such States require the giving of notice to perfect a chattel mortgage, but a few States will enforce a conditional sale contract against subsequent parties who had neither record nor actual notice of it. (Actual notice means that, although the interest was not recorded, the subsequent purchaser or encumbrancer either knew or had cause to know of its existence.) The sole purpose of recording is to give notice; therefore, if a third party learns of the competing interest, even though it is not recorded, he will not be permitted priority over it.

Priority of Perfected Security Interest

The Contractor holding a perfected security interest under a vertical coordination contract is in a more favorable

position than the holder of an unperfected interest, but his priority situation depends in great measure on the nature of the claims which conflict with his interest. If the competing interests are security interests also perfected through filing, the Code applies the "first-to-file" rule to determine priority. Thus, between two security interests perfected by filing, the first interest filed has priority, regardless of whether the security interest attached before or after the filing.[101] In a contest between two security interests, at least one of which was perfected without filing, the priority is determined by the order of perfection.[102] For example, if one interest was perfected by filing a financing statement and another was perfected by taking possession of the chattel, the first interest perfected would have priority.

In these priority rules under the Code, the parties' actual knowledge is not important. In non-Code States, the party obtaining a priority through filing must have had no actual notice of any earlier unrecorded security interest. With this exception, the priority rules in non-Code States generally follow the concept of granting priority to the first security interest perfected.

The combination of the "first-to-file" rule and the abbreviated financing statement authorized by the Code creates the possibility of a "floating" security interest. Under the Code, once a financing statement has been filed manifesting an agreement to hold certain types of property as collateral, this filing gives a priority over later security interests perfected by filing. Thus, if the Contractor files a financing statement which indicates an agreement designating the Farmer's crop or livestock as security for any advances made to him in the future,[103] any subsequent lender who must perfect his interest by filing will come behind such advances, even if the actual advances are made after the subsequent lender has perfected his own interest. The priority established by the filing floats until a debt is created for it to attach to. For example, suppose such a financing statement were filed by the Contractor, and, at a time before any advance had been made by the Contractor, a local bank made a loan to the Farmer secured by a chattel mortgage on his livestock which was immediately filed. The Contractor then advanced money to the Farmer. Under the "first-to-file" priority rule, the Contractor's later advances would relate back to his original filing, and his right would take precedence over those of the bank.

In a case where the original filing did not perfect the security interest because no value was given (that is, no advance was made and no binding promise to make future advances was given), the subsequent lender may be able to obtain a priority under the "first-to-perfect" rule, if he can perfect his interest by some means other than filing. Thus, for example, if the second lender can perfect his security interest by taking possession of the collateral before any advance is made under the earlier filed financing statement, he should obtain a priority as having the first security interest perfected.[104]

Of course, the priority rules cut both ways. If a bank or other lender files a financing statement covering future advances before the vertical coordination contract comes into effect, the Contractor may find his security subordinated to that of the bank.

If a Contractor files a notice designating collateral in only general terms, to take advantage of the "first-to-file" rule, the effect is to limit substantially the outside credit available to the Farmer. If this is not the Contractor's intent, the parties might well consider limiting the extent of the collateral covered by the financing statement, or working out other arrangements that will make the Farmer a better credit risk to other lenders. For example, the Contractor could agree to execute subordination agreements relinquishing his priority over other specific secured parties.[105] In any event, as discussed later in this chapter, purchase money credit ought not to be curtailed by such blanket security interests.

Later Acquired Property

The security agreement may also be drawn to cover property acquired later by the debtor. Here again, under the Code, if the financing statement first filed spells out the intent to bind property to be acquired later, subsequent security holders, other than purchase money interests, are subject to the priority established by the filing. Consumer goods (goods used primarily for personal, family, or household purposes) are not subject to such a clause unless the debtor acquires them within 10 days after the secured party gives value.[106] Code Section 9-204(4)(a) limits the effect

of an "after-acquired" property clause covering crops to 1 year after the execution of the security agreement, except where the security interest is created in a real estate security arrangement. In this connection, it should be recalled that the Farmer has property rights in crops that may cause the attachment of a security interest as soon as they are planted or begin to grow.[107] It is also important to note that Section 9-108 of the Code expressly provides that after-acquired collateral will not be regarded as security for an existing debt in most situations.

In non-Code States, security arrangements that purport to make the collateral secure future advances have been received with varying degrees of acceptance. Generally, the parties have the power to create a security interest in the debtor's property that will absorb future indebtedness, but the creation of such security interests is somewhat more difficult than it is under the Code. Most non-Code States recognize the validity of after-acquired property clauses between the parties, but the effect of these clauses on rights of third parties may be substantially different than the effect under the Code. The major difference is the requirement, in most States, that an independent intervening act, such as filing or delivery of the collateral, must be performed to perfect the interest in after-acquired property against third parties. Other differences relate primarily to form rather than to substance.

Limitations on General Rules

Besides the danger of taking a lower priority than holders of security interests filed or perfected before his own, the secured party may also be subordinated to certain types of security interests in the collateral arising or perfected subsequent to his own. One class of interests that may take precedence over the perfected security interest is the lien for materials or services added to the collateral that arises by operation of law. Under the Code, when a person in the ordinary course of his business furnishes materials or services with respect to goods subject to a security interest, any possessory lien granted such person takes priority over the perfected security interest, unless the statute creating the lien provides otherwise.[108] Thus, if a Farmer takes his tractor, without authorization from the secured party, into a garage for repair, the repairman will, under most State laws, have the right to retain possession of the tractor until his bill is paid. Under the Code, this possessory lien would be good against the secured party as well.

Courts in non-Code jurisdictions have reached contrary decisions in such situations, the tendency being to decide the matter with reference to whether the secured party had "title" to the collateral. For example, if the tractor was financed by a conditional sale contract, the secured party is likely to have first claim on the collateral; if by a chattel mortgage, the repairman's claim is likely to have precedence. This distinction is difficult to defend because the repairman sees the same facts, regardless of the technical method of financing employed.

An even greater limitation on the priority status of certain perfected security interests is the exception created in favor of a subsequent purchase money security interest. For instance, the implement dealer who sells a Farmer a combine on perfected conditional sale contract has a purchase money security interest in the combine that takes priority over an earlier perfected security interest covering all of the Farmer's equipment.[109] Similarly, a perfected chattel mortgage on a tractor taken by the bank that advanced the money for its purchase would take priority over a Contractor's perfected security interest in equipment. However, these purchase money interests must be perfected (filed) within 10 days from the time the debtor takes possession to keep their priority.[110]

The Code also grants a priority to purchase money security interests in inventory, if the security interest is perfected at the time the debtor receives possession of the collateral and if notice is given to any secured party whose interest is known by the holder of the purchase money security interest.[111] Inasmuch as the Code defines farm products to include crops, livestock, and supplies used in farming operations and specifies that if goods are farm products, they are not inventory,[112] it is difficult to imagine a farming situation that would bring the inventory purchase money security priority into play.

The idea of granting special priority to purchase money interests did not originate with the Code. Most non-Code States recognize such priorities where the purchase money security interest is created in a

conditional sale contract. If such an interest is created in a chattel mortgage, however, it is more difficult to obtain a priority over existing security interests.

Still another special priority under the Code that may be extremely important in some vertical coordination contracts relates to a subsequent perfected security interest in crops where new value is given to enable the Farmer to produce crops during the production season. If such a security interest secures value given not more than 3 months before the crops are planted, the interest will take priority over an earlier perfected security interest in the crops, to the extent the earlier interest secures an obligation due more than 6 months before the crops are planted. In the latter case, the subsequent security interest will take priority even though the prior interest was known.[113] This special priority is found in the Code and is not likely to exist in non-Code States.

Special Rights in Enforcement

One important aspect of a perfected secured interest in both Code and non-Code States is the secured party's right to trace his security interest to the proceeds of sale in case the collateral is improperly transferred. In most situations, he will also continue to have a security interest in the collateral in the hands of the transferee as well, but where he does not (for example, sale of goods by debtor in the ordinary course of business), it is all the more important that his security interest attach to the funds. In most non-Code States, the secured party's interest in proceeds is limited to identifiable proceeds. Under the Code, the rights in proceeds include, under limited conditions, unidentifiable proceeds as well. However, the continued perfection of the security interest in proceeds is restricted to a 10-day period, unless the original financing statement covered proceeds, or the security interest in proceeds is itself perfected.[114]

It is clear under the Code,[115] and generally understood in non-Code States as well, that the existence of a security interest does not restrict the debtor's right to transfer the collateral or his creditors' rights to reach it. Thus, a perfected security interest will take priority over a subsequent judgment lien created by attachment, levy, and so on, of the collateral.

Also, with certain important exceptions, subsequent purchasers of the collateral must recognize the rights of a secured party. In the usual case, all the interest which a transferee from the debtor can obtain in the collateral is the debtor's equity--the secured party must have his claim satisfied before the property will be freed of the security interest. A purchaser of chattel paper takes possession free of perfected security interests therein, as do holders in due course of negotiable instruments and documents and bona fide purchasers of securities.[116]

Two exceptions to this pattern of protection of great importance in contract farming relate to purchases of goods in the ordinary course of business and purchases of consumer goods and farm equipment with an original purchase price less than $2,500.[117]

The general rule under the Code is that a purchaser of goods in the ordinary course of business takes the goods free of all security interests, perfected or unperfected.[118] However, purchasers of farm products from a person engaged in farming operations are expressly exempted from this provision. Thus, a person purchasing from a Farmer ". . . crops or livestock or supplies used or produced in farming operations. . ."[119] takes such goods subject to any security interest that has attached to them. The Code does not expressly require that the security interest be perfected, but it is difficult to believe that such a purchaser would take subject to an unperfected security interest about which he knew nothing. The effect of this special exemption relating to farm products is to grant lenders who are financing farm operations a considerable advantage not enjoyed by persons financing ordinary manufacturing processes. Contrariwise, the exception is perhaps a liability when the Farmer's product is ready for sale.

The risk to a party claiming a security interest in consumer goods or farm equipment costing less than $2,500 arises from the fact that the security interest may be perfected without filing--it is perfected automatically.[120] This special type of perfection will create priority over other creditors, but it will be of no avail against subsequent purchasers without notice of the security interest. To avoid the possibility of the security interest being lost through the sale of the collateral to an innocent purchaser, the security interest

should be perfected by filing. If a security interest is first perfected in one manner and later perfected again in another manner, for priority purposes it will be regarded as having been continuously perfected as originally perfected.[121] For example, if a purchase money security interest is taken in a piece of farm machinery (and is therefore automatically perfected), a later filing of the interest as added protection against purchasers of the collateral apparently will not bring the interest under the "first-to-file" priority rules; its priority will be determined on the basis of the time it was first perfected.[122]

To recapitulate, the secured party with a perfected security interest has priority over most holders of unperfected security interests holders of judicially created liens, and most purchasers of the collateral. Within limits, his security interest will continue to attach to the proceeds from sale of the collateral. Also, it is apparent that few of the interests that may take priority over a perfected security interest can cause direct loss to the holder of the perfected interest, for possessory liens for materials and services result from activities that should enhance the value of the collateral. Likewise, purchase money interests result only from the giving of new value, which should not affect adversely an existing security interest.

ACCESSIONS, PROCESSED GOODS, AND FIXTURES

Another priority problem likely to occur in the production contract context involves a security interest in goods which become installed in or affixed as part of other goods, or become so associated with other goods as to lose their original character and become part of a product or mass. If different goods are combined to create something new, a question of priority arises between a holder of a security interest in one of the different goods and a purchaser or holder of a security interest in the whole of the new product. In non-Code States, the continued validity of the former security interest usually depends on the extent to which the former goods are identifiable within the whole. If the former goods have completely lost their original character (for example, feed fed to cattle), the security interest in the feed generally is held to be lost in non-Code States, unless the secured party also had an interest in the finished product. On the other hand, if the original goods are still identifiable in the end product (for example, a new motor in an old tractor), in non-Code States the security interest is continued, but usually no right of removal exists.

The results are quite different under the Code. If the goods subject to the security interest are merely accessions, that is, if they have not lost their identity,[123] a holder of a perfected security interest in the particular goods has priority in the whole over subsequent purchasers, over holders of judicial liens, and over anyone who made subsequent advances under a prior perfected security interest, regardless of whether the security interest attached before or after the goods were installed in or affixed to other goods.[124] Also, a party with an unperfected security interest in separate goods has priority over the above classes unless they acquired their interest without knowledge of the unperfected interest.[125] In no event, however, will a perfected security interest in separate goods take priority over an interest in the whole at the time the security interest attached, without written consent or disclaimer of interest.[126] If the holder of the security interest in the separate goods is determined to have a priority, he may, on default of the obligation secured, remove his collateral from the whole by reimbursing those having interests in the whole for the cost of repair or physical injury occasioned by such removal.[127]

To illustrate, suppose a Farmer purchased a truck by borrowing money from the bank, giving a chattel mortgage that created a security interest in the truck and any bed or machinery permanently attached to the truck and that the chattel mortgage was perfected. Later, the Farmer purchased on conditional sale contract a special bed and power winch, which were then welded and firmly riveted to the truck. The seller of the bed and winch also perfected his security interest. Now, the Farmer has defaulted on his payments and the conditional seller of the bed and winch wants to repossess them. Does his security interest have priority over the bank? Under the Code, the security interest

in the bed and winch attached before they were affixed to the truck. The bank has prior security interest in the whole, but did not make any subsequent advances before the conditional seller's security interest was perfected. Therefore, the seller has a priority and may remove the goods by reimbursing the bank for physical injury, if any, done the truck in the removal process.

If the separate goods subject to a perfected security interest lose their identity in the final product through manufacturing, processing, assembling, or commingling, the security interest continues in the product or mass. The security interest continues also if the financing statement covering the original goods covers in addition the final product.[128] If the security interest was not perfected before the identity of the goods was lost, the security interest is apparently lost as well. If more than one security interest attaches to the final product or mass, they rank equally, according to the ratio which the original cost of the separate goods bears to the cost of the total product or mass.[129]

Finally, priority problems created by fixtures should be considered. Someone once rather whimsically defined a fixture as an item of property with a chattel past and a real estate future. This definition is about as useful as any of the many technical definitions. The basic idea is that a fixture is a type of property that may be subjected to both personal property security interests and real estate security interests because it is originally a chattel, but through its close association with realty it is ordinarily considered to be something that would pass on conveyance of the real estate. The priority questions arise when the same property is claimed as collateral by both real estate and chattel security interest holders.

The first question to be answered in resolving such a priority conflict is whether the item is in fact a fixture. If it is solely real estate or solely personal property, there is no priority problem, for only one type of secured party can have an enforceable security interest. In both Code and non-Code States, the question of whether certain property is a fixture is settled by local law. Under the Code and otherwise, goods incorporated into a structure like lumber, bricks, tile, and so on are real estate and not fixtures.[130] The other extreme is almost as clear--goods that are not affixed or closely associated with realty are not fixtures but are simple chattels. Examples of such goods include ordinary furniture, refrigerators, fans, and so on. If any of these items are "built-in," however, they are likely to be considered fixtures, because a transferee of the real estate would expect to receive them. Examples of items usually regarded as fixtures include furnaces, private water systems, milk house equipment, and certain watering tanks, to name a few.

If the item in dispute is properly classed as a fixture, the Code provides rules for determining the priority of the conflicting claims; these rules are very similar to those discussed above in connection with accessions. If the security interest in the goods attaches and is perfected before they become a fixture, the interest takes priority over all real estate interests.[131] Even if not perfected, it still prevails over all subsequent interests taken with knowledge of it.[132]

If the security interest does not attach until after the goods become fixtures, it will not take priority over any interest in the real estate at the time the security interest attaches. This situation exists unless such other person consents or disclaims.[133] But if the interest is perfected, it will still have priority over an interest taken subsequent to its attachment, and even if the interest is not perfected, it will have priority over subsequent interests taken with knowledge.[134] If the holder of a security interest in the goods is determined to take precedence, he may remove the goods by reimbursing others for damages occasioned by such removal.[135]

Because the Code recognizes priority of security interests in goods over real estate interests in certain cases, it is not surprising to discover that special filing rules are provided for fixtures. The financing statement must be filed in the office where a real estate mortgage would be recorded.[136] Also, when a financing statement involves goods that are to become fixtures, the statement must contain a description of the real estate concerned. A description is sufficient if it provides reasonable identification.[137]

In non-Code States, the priorities between chattel and real estate security interests in fixtures are best described as uncertain. Some jurisdictions look to the form of the chattel security to decide the matter on a "title" basis. Others grant or deny protection to the chattel security holder, on the ground that the chattel recording is not

notice to real estate interests, or base their decisions on the degree of physical annexation present in a given case. No non-Code State goes so far as the Code in permitting the secured party to remove the goods without regard to the damage to the real estate, if the damages are reimbursed. Most States take the contrary position and deny a removal right where substantial injury would be done the premises.

FOOTNOTES--CHAPTER 9

[1] Uniform Commercial Code § 1-201(37) [hereinafter cited as U.C.C.].

[2] Coates, Chattel Secured Farm Credit 7-8 (1954) [hereinafter cited as Coates]; Gilmore & Axelrod, Chattel Security: I, 57 Yale L. J. 517, 530 (1948).

[3] Coates 8.

[4] Gilmore & Axelrod, note 2 supra at 531.

[5] U.C.C. § 9-204(1); Coogan, A Suggested Analytical Approach to Article 9 of the Uniform Commercial Code, 63 Colum. L. Rev. 1, 6 (1963).

[6] Id. at 19-24.

[7] Coogan, note 5 supra at 6, 7.

[8] Ibid.

[9] Id. at 7.

[10] Id. at 9.

[11] U.C.C. § 9-204(4).

[12] U.C.C. § 9-203(1); Coogan, note 5 supra at 16-17.

[13] U.C.C. § 9-203(2); Coogan, note 5 supra at 18.

[14] U.C.C. § 9-204(1).

[15] U.C.C. § 1-201(44).

[16] Coogan, note 5 supra at 11.

[17] Id. at 12.

[18] U.C.C. § 9-204(1).

[19] U.C.C. § 9-204(2)(a).

[20] U.C.C. § 9-102, Comment 1.

[21] Brown, Personal Property 506 (2d ed. 1955) [hereinafter cited as Brown]; Tanner, A Study of the Uniform Commercial Code on Secured Transactions, 58 Dick. L. Rev. 35, 37 (1953).

[22] Coates 10.

[23] Id.

[24] Coates 8; 1 Jones, Chattel Mortgages and Conditional Sales 3, (1933) [hereinafter cited as Jones].

[25] Coates 8; 1 Jones 4.

[26] Dennon, Secured Transactions 132 (1963).

[27] Coates 8; Tanner, note 21 supra at 38.

[28] Dennon, Secured Transactions 125-26 (1963).

[29] Id. at 133.

[30] Ibid.

[31] U.C.C. § 9-311.

[32] Ibid.

[33] Id. at Comments 1 and 2.

[34] Ibid.

[35] U.C.C. § 9-205.

[36] 268 U.S. 353 (1925).

[37] U.C.C. § 9-205, Comment 1.

[38] Ibid.

[39] U.C.C. § 9-205.

[40] U.C.C. § 9-208 and Comment 1.

[41] U.C.C. § 9-208(2).

[42] Ibid.

[43] Ibid.

[44] Ibid.

[45] Ibid.

[46] See Harper & James, Torts § 3.15 (1956).

[47] U.C.C. § 9-207.

[48] U.C.C. §§ 9-207, Comment 1; 1-102(3).

[49] U.C.C. § 9-207, Comment 1.

[50] U.C.C. § 9-207(2)(a), Comment 1.

[51] U.C.C. § 2-702(2)(d).

[52] Ibid.

[53] U.C.C. § 9-207(2)(c).

[54] U.C.C. § 9-207(2)(e).

[55] U.C.C. § 9-207(4).

[56] Ibid.

[57] Ibid.

[58] U.C.C. § 9-207(2)(b).

[59] U.C.C. § 9-207(3).

[60] Ibid.

[61] U.C.C. §§ 9-501, Comment 2; 9-503.

[62] U.C.C. § 9-503.

[63] U.C.C. § 9-501(4).

[64] U.C.C. § 9-501(4), Comment 5.

[65] U.C.C. § 9-502.

[66] Ibid.

[67] Ibid.

[68] U.C.C. § 9-504(1).

[69] Ibid.

[70] Ibid.

[71] U.C.C. § 9-504(2).

[72] U.C.C. § 9-504(3).

[73] Ibid.

[74] Ibid.

[75] U.C.C. § 9-504(4).

[76] U.C.C. § 9-505(1) and (2).

[77] Ibid.

[78] Ibid.

[79] U.C.C. § 9-506.

[80] Ibid.

[81] Ibid.

[82] Ibid.; U.C.C. § 9-501.

[83] U.C.C. § 9-501, Comment 4.

[84] U.C.C. §§ 9-501(3)(a), 9-504(2).

[85] U.C.C. §§ 9-501(3)(a), 9-502(2).

[86] U.C.C. §§ 9-501(3)(b), 9-504(3); see § 9-504, Comment 5.

[87] U.C.C. §§ 9-501(3)(c), 9-505(2).

[88] U.C.C. § 9-507.

[89] Ibid.

[90] Id. Comment 1.

[91] U.C.C. § 9-312(5)(c).

[92] U.C.C. § 9-301(1)(a), Comment 2.

[93] U.C.C. § 9-301(1)(b).

[94] U.C.C. § 9-301(3).

[95] U.C.C. § 9-301(1)(c).
[96] But see U.C.C. § 9-307(1).
[97] See U.C.C. § 9-305.
[98] See U.C.C. §§ 9-401, 9-402; if the collateral is a type controlled by title certificate laws, the Uniform Commercial Code also permits perfection of the security interest by proper notation on the title certificate. U.C.C. § 9-302(3)(b).
[99] See U.C.C. § 9-402(3), Comment 1.
[100] U.C.C. § 9-303(1).
[101] U.C.C. § 9-312(5)(a).
[102] U.C.C. § 9-312(5)(b).
[103] This is authorized by U.C.C. § 9-204(5).
[104] See U.C.C. § 9-312(5)(b).
[105] See U.C.C. § 9-316.
[106] U.C.C. § 9-204(4)(b) and U.C.C. § 9-109(1).
[107] U.C.C. § 9-204(2)(a).
[108] U.C.C. § 9-310.
[109] U.C.C. § 9-107.
[110] U.C.C. § 9-312(4).
[111] U.C.C. § 9-312(3).
[112] U.C.C. § 9-109(3).
[113] U.C.C. § 9-312(2).
[114] U.C.C. § 9-306(3).
[115] U.C.C. § 9-311.
[116] U.C.C. § 9-308.
[117] U.C.C. § 9-307.
[118] U.C.C. § 9-307(1).
[119] U.C.C. § 9-109(3).
[120] U.C.C. § 9-302(1)(c), (d).
[121] U.C.C. §§ 9-312(6), 9-303(2).
[122] See U.C.C. §§ 9-302(1)(d), 9-312(4), 9-312(5)(b).
[123] U.C.C. § 9-314(1).
[124] U.C.C. §§ 9-314(1), (2), (3).
[125] U.C.C. § 9-314(3).
[126] U.C.C. § 9-314(2).
[127] U.C.C. § 9-314(4).
[128] U.C.C. § 9-315(1)(a) and U.C.C. § 9-315(1)(b).
[129] U.C.C. § 9-315(2).
[130] U.C.C. § 9-313(1).
[131] U.C.C. § 9-313(2).
[132] U.C.C. § 9-313(4).
[133] U.C.C. § 9-313(3).
[134] U.C.C. § 9-313(2), (4).
[135] U.C.C. § 9-313(5).
[136] U.C.C. § 9-401 (any of three alternative subsections 1).
[137] U.C.C. § 9-402(1) and U.C.C. § 9-110.

CHAPTER 10. BAILMENTS

Bailment is one of the devices used by Contractors to protect their investments in subject-matter inputs and to help assure receipt of the resulting commodity at market time. Generally, a bailment is a transfer of possession of personal property from the owner (the bailor) to another person (the bailee), so the bailee can take some type of special action in relation to the bailed goods.[1]

Some examples of bailments may be helpful in understanding the arrangement. If a Farmer hauls grain to a mill and delivers possession of it to the miller to have it ground into feed, this transfer ordinarily creates a bailment. When the purpose of the bailment is accomplished, the resulting product is either returned to the bailor or disposed of as he directs, but in either case the ownership of the feed is clearly with the Farmer and never with the miller.[2] Likewise, a Contractor who furnishes the chickens and feed in a contract with a Farmer who is to raise the flock may retain ownership of the chickens throughout the entire period. Similarly, under vertical coordination contracts, a packing company may purchase cattle and arrange for a Farmer to fatten them for slaughter, or a canning company may provide a Farmer with seeds to be planted for a specialty crop. Each of these examples will be considered more carefully later, but a few general observations are made here.

First, it seems clear that no sale was intended under any of the arrangements. Second, the legal title of the goods involved remained in the bailor.[3] Third, the bailee received possession of the goods with the consent of the bailor and by the bailee's own voluntary act.[4] Finally, the purpose for which the bailee took possession was the bailor's purpose, as set forth in the contract. These factors are the principal elements of a bailment contract arrangement.

RIGHTS AND DUTIES

The bailee's basic rights are (1) possession of the goods until the bailment is finished and (2) use of the goods to the extent the agreement allows.[5] Perhaps the right of use is the most significant, since it gives the bailee under vertical coordination contracts the right to change the nature of the goods. The Farmer's right to make full use of the bailed property is essential to the purpose of the ordinary vertical coordination contract, whether the property is seed, plants, or livestock. His right of possession creates in him the ability to recover fully against any third person who damages or takes away the bailed goods.[6]

A duty of care is imposed on the bailee to handle the bailed goods properly. The bailee must handle them with ordinary diligence, for he will be liable for any loss or damage which he negligently causes. In determining whether due care was taken, consideration must be given to such factors as the value of the goods bailed, the place where the goods are kept, and the custom of the community with regard to the handling of like goods.[7]

The standard of care imposed by law may be altered by the production contract. Thus, while a bailee is not an insurer, he can assume that degree of liability under a properly drawn bailment agreement. The courts seem especially willing to permit the parties to contract as to who will bear the loss caused by specific events. For example, in one case, the bailee agreed to pasture the bailor's animals, but warned that some of his fences were down, and stated that he would not be liable if the animals strayed off his farm. Usually, if his inadequate fences allowed the animals to stray, a bailee would be held responsible for any loss. However, the court said an agreement that the bailor would bear this risk was valid.[8]

An allied, but probably distinct, duty of the bailee is to put the bailed goods to the use specified in the contract. Use of the goods contrary to the terms of the bailment

agreement may create liability on the part of the bailee. Thus, if the miller, in the example given earlier, used the Farmer's grain to make flour rather than feed, such use would be inconsistent with the bailment and the bailor's rights thereunder; the miller, therefore, would be liable for breach of the bailment contract. [9]

The bailee also has the duty to return the bailed goods to the bailor on demand when the bailment purpose is completed. This duty is of the highest order, because it results in absolute liability on the bailee for delivery to the wrong party. [10]

Bailment arrangements provided for in vertical coordination contracts seldom involve a public recordation of the interests created, so a third party is unlikely to have notice that a bailment exists. The rule in most States is that a bailee who transfers bailed property in violation of the bailment agreement cannot pass better title than he himself had, even to a good-faith purchaser.[11] In other words, a bailor has the right to repossess the bailed goods from a transferee of the bailee, even though that transferee did not know of the bailment and paid full value for the goods. The maxim of caveat emptor (let the buyer beware) is rigorously applied in a bailment situation, even though the purchaser's right to recover damages for fraud from the wrong-doing bailee may be of little value.

In some cases, however, a bailor may be prevented from denying the existence of the bailee's power of sale. This doctrine, called "equitable estoppel," applies only in cases where the bailor has clothed the bailee with the apparent power to sell.[12] For example, if the Farmer bailee, who possessed cattle for fattening under a vertical coordination contract, was also in the business of buying and selling cattle, a good-faith purchaser of the bailed cattle might prevail over the Contractor-bailor on the ground that the Contractor's bailment to one who regularly bought and sold cattle created an apparent power of sale in the bailee which the Contractor is not permitted to deny. However, mere possession of the bailed goods by the bailee is generally not considered sufficient grounds for estoppel.[13] Thus, in the above example, if the Farmer were not in the business of buying and selling cattle, the Contractor could assert his title and recover the cattle from a purchaser.

Since the bailor retains title and full ownership rights in the goods, he is generally protected against the bailee's creditors, who have no more rights in the bailed items than the bailee has--the rights to possess and use.[14] This relatively high degree of protection of the bailor's interest is usually the compelling reason to establish a bailment arrangement, in preference to an ordinary security interest, in vertical coordination contract situations.

The law is somewhat unsettled regarding the bailor's duty to compensate the bailee for expenses which the bailee incurs while performing his bailment duties but which are not provided for in the contract. For example, in a bailment of baby chicks by a Contractor to a Farmer for raising broilers, the Farmer may find it necessary to purchase medicines and obtain the services of a veterinarian while raising the broilers. Should these expenses be borne by the bailor or the bailee, if nothing is said about them in the production contract? One answer would be to treat the bailee as the bailor's agent for the purpose of contracting for such expenses and to make the bailor responsible to the suppliers of necessary goods and services. The application of this approach is probably limited, however, to those cases where the bailee's expenditures were reasonably necessary and the bailee was unable to give notice so the bailor could decide himself what ought to be done.[15] Local practice, of course, may be a major factor in making the determination.

BAILMENTS AND THE UNIFORM COMMERCIAL CODE

The impact of the Uniform Commercial Code on the law of bailment is by no means clear, but many lawyers believe that bailment arrangements are not generally altered by the Code. One difference between the bailment rules sketched above and Code regulations occurs when the bailee comes within the Code definition of a "merchant." Under the Code, a merchant has the power to pass good title to the goods in his possession to a buyer in the "ordinary course of business."[16] Using the feeder cattle example previously cited, if the Farmer could be classified as a merchant, he might defeat the interest of the Contractor by selling the cattle to an innocent purchaser. Although farmers are generally excluded from the "merchant"

definition, the Farmer might be classed as a merchant if he is handling the sale of a sufficient number of cattle so that he can be said to have specialized knowledge as to their selection, care, and sale.[17] The buyer, in order to gain the protection of the Code's "merchant" provision, must be in good faith and without knowledge of the fact that the goods were under bailment and the bailee was not authorized to sell them.

The effect of the "merchant" ruling would be closely analogous to the effect of the doctrine of equitable estoppel, which protects the good-faith purchaser under pre-Code law in cases where the bailor has clothed the bailee with the apparent power to sell. The similar result under the different types of law indicates the central desire on the part of lawmakers to protect an innocent purchaser in a commercial transaction.[18]

As mentioned previously, one reason why the Contractor would bail baby chicks rather than sell them would be to protect himself against a good-faith purchaser from the Farmer. Because it may be difficult to tell, as a practical matter, whether a specific Farmer would be considered a merchant, the Code might be regarded as discouraging certain bailment arrangements.

Another consideration in Code States is the treatment of items which fall within the Article 9 definition of a "security interest." The commissioners' official comment establishes a two-part test to be applied to determine whether a security interest is involved in a transaction.[19] First, is the transaction intended to have effect as security? Proof of an intent to create something in the nature of a security interest might be found in the typical bailment situation, although this evidence is likely to be ambiguous. Second, are the goods of the type subject to Article 9?[20] In the case of cattle and crops, the answer to this second question is clearly affirmative, since the Code specifically states they can be subject to a security interest.[21]

In the feeder cattle situation, for example, apparently the courts might hold the bailment arrangement a security device. The consequence of this classification could be to improve the protection of the bailor's interest in certain situations, but it would also add to the bailor's responsibilities regarding the bailed property and the bailee. The Contractor, if he had a perfected security interest, would retain priority over the Farmer's creditors. More important, even if the Farmer-bailee were found to be a merchant, he would not be able to sell the goods free of a perfected security interest, since the bailed goods were farm products. The Contractor's protection against a good-faith purchaser would thus be fortified if the Contractor were found to have a security interest under the Code. Of course, classifying agricultural or like arrangements as security interests would make such arrangements subject to all Article 9 provisions concerning secured transactions. Some of these provisions, which were discussed in chapter 9, are not advantageous to the bailor.

The ordinary bailment contract does not specify an intent to create a security interest, so some difficulties may arise. For example, a court may consider the arrangement a classic bailment situation if the bailor retains title not necessarily for security reasons and may refuse to apply the Article 9 provisions.[22]

The fear that a Farmer-bailee might qualify as a merchant and pass good title to a buyer in the ordinary course of business led the drafters of the Code in one agricultural State to include specifically in the definition of security interest ". . . any interest of an owner of farm products whose possession is entrusted to a person engaged in farming operations."[23] Such a provision would clearly cover many vertical coordination contracts which might otherwise create bailments. The drafters believed that if a security interest in farm products was to be protected, so should the ownership interest of a bailor.[24] The natural implication of such an addition is that agricultural bailor-bailee arrangements are not covered as security interests under the regular Code provision.

In review of the discussion of bailments, the canner-grower vertical coordination contract may be considered. One initial problem is whether the Contractor can provide the Farmer with the seeds to be planted for a crop and retain the title to the seeds <u>and</u> to the future crops. Courts have held that, if a bailment was created in such cases, the title to the crop was in the Contractor.[25] The basis of the holding is that the seed is the essential element of the crop and its bailment is like any other, so the principle is applied that the Farmer-bailee is to return the goods which are the product of the property bailed.[26]

In a leading case, the plaintiff, a Wisconsin agricultural cooperative association,

sought to recover, from a canning-company Contractor, commissions on sales of peas by a Farmer to the Contractor. The Farmer was a member of the cooperative, which had limited the rights of its members to sell committed produce to outside buyers. The arrangement in the case was an attempt at a bailment. The Contractor provided the seeds, and the contract stated that the title to the seed and crop remained in the Contractor. The risk of loss, however, was to be on the Farmer. If the arrangement was a bailment, the restrictive agreement with the cooperative affecting sales was of no avail. The court held it was a valid bailment arrangement. [27]

The contrary argument is strong. [28] The seed is only one of several essential elements of a harvested crop. The soil, air, sunlight, and Farmer's labor are just as necessary. This view leads to the conclusion that the transaction involved is a sale, or at least, an attempt by the Contractor to retain a security interest in the crop. Even if it is conceded that retained title in the seed does not create title in the crop, the important advantages of a bailment can be retained by the Contractor, if the interest involved can be considered a security interest.

The Code provides that a security interest can be created in future crops if the seed is to be planted within 1 year after the security agreement is made. [29] If the Contractor can establish a security interest, he is protected against the creditors of the Farmer and may also recover the seed or crop sold to a good-faith purchaser in the ordinary course of business.

To summarize, in most instances the Code does not affect bailment arrangements. Where there is some risk that the bailee might be found to be a merchant, the bailor should consider treating his interest as a security interest to fortify his position against purchasers from the bailee.

FOOTNOTES--CHAPTER 10

[1] 4 Elliott on Contracts § 2985 (1913).

[2] Brown, Personal Property §§ 77, 86 (2d ed. 1955) [hereinafter cited as Brown].

[3] Brown § 77.

[4] Id. §§ 75, 76.

[5] Id. § 88.

[6] Id. § 90.

[7] Id. § 81.

[8] Coffield v. Harris, 2 Tex. Ct. App. Civ. Cas., Sec. 315 (1884).

[9] An action for conversion may also exist in a situation such as described. See Brown § 88.

[10] Brown § 86.

[11] Vold, Law of Sales § 78, at 391 (1959).

[12] Ibid.

[13] Id. at 393.

[14] See, e.g., Albers Milling Co. v. Farmers Produce Co., 222 F.2d 915 (8th Cir. 1955).

[15] Brown § 89.

[16] U.C.C. § 2-403(2).

[17] U.C.C. § 2-104(1).

[18] See U.C.C. § 2-403, Comment 1.

[19] U.C.C. § 9-102, Comment 1.

[20] Ibid.

[21] U.C.C. § 9-109(3).

[22] See 1954 Wis. L. Rev. 353, 363, where the author states that the title retained in the Green Giant case, note 27 infra, was not for security.

[23] Bergsten, Intentional Variations From the Uniform Commercial Code as Enacted in Iowa. The author notes the problems here discussed in the comment on the change of § 1-201(37).

[24] Ibid.

[25] See, e.g., D. M. Ferry & Co. v. Forguer, 61 Mont. 336, 202 Pac. 193 (1921).

[26] Ibid.

[27] Cash Crops Co-op v. Green Giant Co., 263 Wis. 353, 57 N.W. 2d 376 (1953).

[28] The results reached in the cases discussed have been subject to much criticism. See Note, 1951 Wis. L. Rev. 175, 177 (1951); Brown § 77, at 281-82.

[29] U.C.C. § 9-204.

CHAPTER 11. CLASSIFICATION OF VERTICAL COORDINATION CONTRACTS

INITIAL CLASSIFICATION SYSTEM

Contracts may be classified by several methods, depending on the specific purposes of the classification. A classification might be based on product, legal relationship, methods of payment, combinations of the three phases of production, methods used to determine price, or any other relevant criterion. Researchers, however, have most often classified vertical coordination contracts by product, such as broilers, cherries, tomatoes, hybrid seed corn, and so on.

The theories of vertical coordination presented by Mighell and Jones, Roy, and others referred to in chapter 1 all suggest the value of analysis of vertical coordination contracts in a frame of reference that concerns the transfer of entrepreneurship from Farmer to Contractor.

This chapter presents the results of an experimental attempt (1) to isolate the various elements in the vertical coordination contracts which affect entrepreneurial control; (2) to devise a rough measure of the degree to which specific contracts transfer control of each of these elements from the Farmer to the Contractor, and (3) to devise a method for using this measure to classify contracts according to the degree of integration they achieve.

Entrepreneurial attributes of an unencumbered sole proprietorship operation include ownership of input resources and the resulting products, location of management and marketing control, establishment of standards of husbandry, assumption of risk and uncertainty, allocation of responsibilities, techniques of making contributions, and so on. In vertical coordination contracts new elements of entrepreneurship are introduced and old elements take on new meaning. Among elements that may be added are expressed warranties, denied liabilities, restricted right of assignment, permitted excuses for nonperformance, security devices, and right of enforcement.

The benchmark firm for the analysis was visualized as a complete and independent unit with all of the traditional entrepreneurial functions in the firm. For purposes of the benchmark, it did not matter whether the farm was legally classified as a sole proprietorship, partnership, corporation, or other structural form. Nor did it matter whether it was a landlord-tenant operation. While a whole series of legal and economic arrangements may be established between landlord and tenant, the face presented to the Contractor is that of a single farm firm. The benchmark farm firm was a totally independent structure; it carried out all production operations and performed all marketing functions; it provided all of its own resources, technology, and management; and it bore all risks and uncertainties and reaped all benefits.

Although contracts cover many different products and production situations, it was assumed that the application of legal and economic principles would be similar in contracts for different products. It was also assumed that the provisions in contracts for the same product might vary widely. Under these assumptions, a system that classifies contracts in accordance with legal and economic concepts should not be tied to products. The system, the authors concluded, should be designed to classify contracts according to the degree to which various elements of entrepreneurship are shifted by the contractual agreement from the Farmer to the Contractor. Thus, at one extreme is the situation found on a farm operated by an unindebted sole proprietor, and at the other extreme is the situation found on a farm which has been fully integrated with an off-farm firm.

In earlier studies of shifts of various elements of entrepreneurship, the emphasis has been on management control; the tendency has been to overlook or deemphasize shifts in benefits and burdens. In this study, effort was made to maintain equal emphasis on these two aspects of production contracts. A question of constant concern was, what benefits does the Farmer receive and what burdens does he shift in return for the elements of entrepreneurship (for example, management control) that he relinquished in entering into a contract farming arrangement?

The chief questions to be answered in devising the classification system were, (1) what elements of entrepreneurship were transferred from Farmer to Contractor, and (2) what was the magnitude of the shift? As the research progressed, it became evident that the several elements could not be considered in isolation, for they were often closely intertwined. It also became evident that not only should shifts of rights and duties from the Farmer to the Contractor be considered, but also reciprocal shifts of benefits and burdens between the Contractor and Farmer. That is to say, the quid pro quo characteristic of contracts had to be reckoned with.

The entrepreneurial elements in the contracts were grouped into 10 major categories. Initially, the components of a gradation scale for rating contracts for integration achieved in each category represented almost verbatim phrasing lifted from the contracts, but it was immediately obvious that for some of the categories the gradation scale would have 50 to 100 subitems. Thus, it was necessary to reduce the items for each category to a few statements of fact, finally six, with which the actual words of each contract could be compared.

The 10 categories of contract elements, arranged under the three phases of production, are as follows:

Acquiring the input--production phase 1.

1. Subject-matter input decisions.
2. Ownership and risk of loss of input.

Producing the commodity--production phase 2.

3. Production decisions.
4. Standards of husbandry.
5. Ownership during production.
6. Risk of loss during production.
7. Restrictions on Farmer.

Marketing the output--production phase 3.

8. Marketing decisions.
9. Price of product.
10. Acceptability of product.

The gradation scale used to determine the degree of integration attained under the contract provisions in each of the above categories is discussed below.

Acquiring the Input--Production Phase 1

Category 1. Subject-Matter Input Decisions

The authors hypothesized that the degree of integration resulting from contract provisions governing decisions about subject-matter inputs varied with the allocation of these decisions to the Farmer or the Contractor, particularly those regarding quantity and quality, responsibility for payment, and determination of source of supply for the input. These allocations were often stated in the contracts in production terms, but less obvious statements relating to the subject-matter input were included in the warranties of the Farmer and the security devices provided for the Contractor.

Control over the quantity and quality of the input was considered to be the major indicator of the degree of integration via subject-matter input decisions. But varying relationships between source of supply and payment also suggested variations in the degree of integration. For example, less integration was presumed when the Contractor furnished the input and received a payment for it than when the input was furnished by the Contractor without charge.

A warranty that the Farmer will use only the input furnished or approved by the Contractor increases the quantity of input decisions shifted to the Contractor. Transfer of input decisions may also be evidenced by provisions prohibiting the Farmer from selling the input to other persons, or permitting the Contractor to refuse products grown from an input other than the one he furnishes, or requiring the Farmer to use only the input supplied by the Contractor. Some contracts contain a security device to protect the Contractor's interest in the input.

A farmer operating as a sole proprietor without a contract furnishes the subject-matter input and makes all decisions relative to it. It is assumed that, if a contract makes no reference to the party who supplies the input, or the method of payment, or the quantity or quality of the input, the decisions are the Farmer's unless the nature of the contract or the context indicates otherwise--an unlikely situation. Some contracts, as in the fruit industry, do not specify quantity and quality of input, because the Farmer furnishes the fruit-bearing trees.

The six criteria groups for measuring the degree of integration based on contract provisions concerning subject-matter input decisions, and the number of contracts meeting these criteria, are given below:

Criteria group	Number of contracts	Description
A	28	Input is supplied by Farmer, who determines quantity and quality and pays for it; warranty and security devices not involved.

Criteria group	Number of contracts	Description
B	56	Input is supplied at Farmer's option, or input in possession of Farmer becomes a part of the contract; Farmer pays for it; warranty and security devices are absent.
C	150	Input source is Contractor, or other nonfarm source inserted in the contract at time of execution; but Farmer decides quantity and quality, and pays for the input as provided in the contract.
D	64	Input is supplied by Contractor, or at Contractor's option, or by others specified by Contractor; quantity and quality of input are stated in exact terms, approximate terms, or as being sufficient; Farmer is restricted from using another input, or selling or disposing of the input to others; warranties and security devices give additional control to the Contractor; and Farmer may pay for input in cash or kind.
E	104	Input is supplied by Contractor, or by others at Contractor's discretion at no charge to Farmer; quantity and quality are stated in contract as necessary, sufficient, or required, to be determined by Contractor; and Contractor may refuse products grown from input other than that supplied by Contractor.
F	18	Contractor has complete discretion over the input, which is supplied at no cost to Farmer.

Category 2. Ownership and Risk of Loss of the Input

The degree of integration brought about by production contracts is influenced by which party holds title to the input, who bears the risk of its loss, who determines the source of the input, who pays for it, and whether the contract contains a warranty or disclaimer of warranty of the input's quality. Some of the criteria used to measure the effect of contract provisions dealing with these matters are similar to those developed for use with subject-matter input decisions (category 1).

An unencumbered sole proprietor usually has title to the subject-matter input and bears the risk of its loss. In full integration, the off-farm firm owns the input and is responsible for its loss. The situation is complicated, however, if one party owns the input, while the other bears the risk of its loss. In setting up the criteria for this category, integration was considered to increase if the Contractor owned the input, or if the input was from a source specified by the Contractor with no warranty as to quality, but the risk of loss was borne by the Farmer.

Risk of loss, when not provided for in the contract, does not depend on ownership in the Code States as it does in some non-Code States. The contract may provide, however, for the association of ownership and risk of loss that best fits the needs of the parties. Risk of loss follows beneficial ownership of the input in many contracts. If the locus of title is not specified, it is usually implied from other contract terms. The party who bears the cost of the subject-matter input usually has beneficial ownership of the input. Therefore, if title was not specified and the Farmer paid for the input, the Farmer was regarded as the owner and the contract was considered as representing a lower degree of integration than if the Contractor contributed and owned the input. When the Contractor supplies the input, he can retain title without having that fact noted in the contract. Time and method of payment for the subject-matter input, in the absence of better criteria, assisted in determining whether the Contractor was merely a supplier of the input or whether he really contributed and owned the input.

In some contracts, the Contractor may seek to limit or avoid liability for the quality of the subject-matter input he supplies, through a disclaimer of any express or implied warranties of quality. If the Contractor does not warrant the quality of the product he furnishes, or if he disclaims any implied warranty of quality, a contract allocation of risk of loss is involved, particularly if the allocation differs from the open market.

The criteria for determining the degree to which contract provisions for ownership and risk of loss of the subject-matter input achieve integration, and the number of contracts meeting each criterion, are listed below:

Criteria group	Number of contracts	Description
A	56	Subject-matter input supplied by Farmer from sources other than Contractor; title and risk of loss in Farmer, who pays for the input; and warranty of quality is between Farmer and his supplier.
B	22	Subject-matter input supplied from those in Farmer's possession or at Farmer's option from Contractor's source; title and risk of loss in Farmer, who pays for the input; and no disclaimer of warranty of quality by Contractor unless within local practice.
C	74	Subject-matter input supplied by Contractor at Farmer's option, or obtained by Farmer from source agreed to in contract; title and risk of loss in Farmer, who pays for the input; and no disclaimer unless within local practice.
D	128	Subject-matter input supplied by Contractor, or by another at Contractor's option but at Farmer's cost; title and/or risk of loss in Farmer or shared; and Contractor either disclaims liability for quality of input supplied or does not give an affirmative warranty of quality.
E	115	Subject-matter input contributed by Contractor with no direct charge to Farmer; title in Contractor and risk of loss in Farmer or shared; and Contractor disclaims liability for quality of input.
F	25	Subject-matter input supplied by Contractor, who holds title and bears risk of loss.

Producing the Commodity--Production Phase 2

Category 3. Production Decisions

Method of making production decisions is another indication of the degree of integration provided for in the contracts. In crop production, production decisions usually encompass such items as date of planting, planting practices, cultivation practices, harvesting practices, and date of harvesting.

Selected production activities and the method or combination of methods for their control were examined separately. The level of integration was determined by the extent of control implicit in the method and on the number and nature of practices controlled.[1]

Full control of production practices is exercised by the Farmer in the absence of specific contract provisions. Sometimes, a contract affirmatively or by implication places the locus of control in the Farmer, but usually affirmative provisions relate to transfer of control from the Farmer. If the contract refers to any of the applicable production practices, it usually indicates whether a shift of control is made. When some of the practices and controls are specified but others are not mentioned, presumably the Farmer controls those not mentioned. If applicable production practices are specified in the contract in exact terms, the Farmer's deliberate acceptance in advance is assumed.

Production practices may be controlled jointly as a result of exact specifications in the contract. These, too, may be articulated with respect to only a portion of the applicable practices. Whether the implementation of these precise specifications is controlled by the Farmer or the Contractor, it is assumed that the control is shared mutually because the parties agreed to them in the contract.

Methods utilized by the Contractor to control production practices also represent a measure of the transfer of entrepreneurship. Of course, applicable production practices vary with the type of crop, and between crops and animals. In the production of tomatoes, for example, the dates of planting, cultivating, and harvesting are important, but in growing apples under contract, the date of planting and planting practices usually are inconsequential--they have been performed already.

In establishing the following criteria, integration was assumed to increase as the

Contractor increased his control over production activities. Complete control by the Farmer is considered the polar opposite of performance of all production activities by the contractor.

The criteria developed for classifying contracts according to how provision for production decisions affected degree of integration, and the number of contracts meeting each criterion, are listed below:

Criteria group	Number of contracts	Description
A	39	Farmer controls all production decisions relative to all practices, some of which may be specified in general terms in the contract.
B	128	Farmer makes decisions about those production practices specified in the contract, pursuant to exact specifications; or Farmer agrees either to notify Contractor of facts relative to certain operations or to keep records on production practices.
C	17	Only one or two production practices are mentioned in the contract and one or both, or a portion of one or both, are controlled by Contractor through inspection, guidance by fieldman, requirement of permission or consent, and so on.
D	65	Contractor makes decisions about more than two of the important production practices, pursuant to exact specifications in contract or direct supervision.
E	160	Contractor has general supervision over all or all important production practices through instruction, direction, specification, and so on; and Contractor may perform limited production activities.
F	11	Contractor has general supervision over all production practices, or actually performs all practices, or a combination of the two.

Category 4. Standards of Husbandry

Standards of husbandry refer to the manner in which a reasonable man would perform under like circumstances in light of established practices in the community. Under sole proprietorship, a farmer is presumed to have complete control over his standards of husbandry. A vertical coordination contract, on the other hand, may set forth standards or even specify the party who determines the standards and how they are to be maintained. For example, it is not uncommon for a contract to provide that the Farmer will "... follow recommendations of Contractor's fieldman in the performance of production functions." Community standards, in this way, may be established largely by the Contractor where a monopsony market exists.

Standards of husbandry during the production phase may be left to the Farmer explicitly or by absence of a contract provision; they may be stated as general rules of good husbandry; they may be specified in detail; or they may be determined by the Contractor pursuant to a clause placing the Farmer under the Contractor's direct supervision. In the contracts studied, at least 32 different wordings were used to phrase the standards of husbandry required during the production phase.

In setting up the criteria for this category of contract provisions, it was assumed that in the absence of a contract provision the Farmer did not divest himself of his right to set his own standards. An agreement to conform to general standards was considered to be the first step in divestment. If the Farmer and the Contractor agreed to relatively precise standards, this was assumed to represent further divestment of the Farmer's right to set standards. Reference to compliance with a law, for example, a law governing the use of pesticides or the certification of seeds, was regarded as neutral insofar as a sole-proprietor farmer must also comply with such legal rules.

The power given the Contractor to determine husbandry standards in clauses that described performance in terms of the Contractor's approval or requirements, or according to the Contractor's feeding program or to the instructions, suggestions, advice, or directions of the Contractor's fieldman, also was interpreted as shifting control from the Farmer to the Contractor. Sometimes a contract provides that the standards of husbandry are those established by

a trade association or the bylaws of a cooperative. These provisions are interpreted as standards set out in the contract to which the Farmer agrees in advance, not standards left to be determined by the Contractor. The ultimate transfer occurs when the Contractor performs most or all of the production activities.

The criteria for classifying vertical coordination contracts as to their provisions on standards of husbandry, and the number of contracts meeting each criterion, are as follows:

Criteria group	Number of contracts	Description
A	2	Farmer decides the standards of husbandry, usually by virtue of the absence of any contract provision.
B	47	Farmer promises to maintain standards measured in his terms; for example, as if animals were his own.
C	162	Farmer promises to maintain standards in accordance with general rules of good husbandry, phrased, perhaps, in terms of his best efforts or his best ability and attention.
D	67	Some of the standards (a contract seldom tried to cover all details of production) are set out in relatively specific detail, which may be stated by reference to rules and regulations established in bylaws of a cooperative or standards established by a trade association of Contractors.
E	135	Standards of husbandry are to be established by inspections, suggestions, advice, recommendations, or approval of Contractor's fieldman; or according to the Contractor's management and feeding program or other program specified by the Contractor, and under which Contractor assumes virtually complete control over the standards of husbandry.
F	7	All production activities are performed according to the directions or instructions of the Contractor's fieldman or subject to close supervision and constant inspection by the Contractor; or most or all activities were performed by the Contractor.

Category 5. Ownership During Production

Ownership of product during production may have an impact on the degree of integration through (1) production practices, (2) security interest, (3) quality of final product, and (4) risk of loss. The contracts were classified within an analytical framework that assumed a relationship exists between the locus of ownership of the product during the production phase and the degree of integration. Emphasis was on ownership specifications in the contract rather than the law, in the absence of a contract provision. In the criteria, ownership of the product is an indicator of the right to exert control over production practices. Ownership is also a technique or form of obtaining a security interest in the product. A contractor may seek assurance of delivery, or delivery of a desirable quality product, at a particular time by obtaining early ownership. Consequently, if the Contractor owned the product while it was being produced, this indicated that the degree of integration was increased.

If the Contractor supplies the input, he will often retain title during the production and marketing phases. If the Farmer furnishes the input, he may retain title throughout production, or he may transfer title to the Contractor prior to final delivery of the product.

Under contract provisions, problems concerning title to the product during the production phase may arise when the Contractor furnishes the subject-matter input and the title to it passes to the Farmer. If the Farmer gains title to the input, it is important to determine the time of passage of title to the Contractor. Title may pass to the Contractor at the execution of the contract, during the production phase, upon delivery, upon acceptance, or at some time during the processing stage. In scoring the

contracts, different degrees of integration were suggested by the different times of title passage.

In an unindebted sole proprietorship, title and ownership are usually retained in the farmer until the product is sold, delivered, and accepted. In a fully integrated operation, title to the product remains with the off-farm firm throughout the production phase. In the intermediate situations, the Contractor may have title during production through two methods--(1) retention of title to the subject-matter input, as through a security interest, or (2) transfer of title from the Farmer at some stage in the process.

Criteria for determining the degree of integration resulting from ownership of the product during the production phase and the number of contracts meeting each criterion are listed below:

Criteria group	Number of contracts	Description
A	13	Farmer has title to product; title passes under legal rules to the Contractor if the marketable product is sold to him.
B	257	Farmer has title to product; title passes earlier than under general law, but not before harvest or maturity; for example, upon delivery of first load of product, or when the product is harvested.
C	13	Contractor has title, but only to secure payment of money; beneficial title is in the Farmer.
D	7	Both parties have title at different periods; for example, title may pass when animals reach a certain age, when Contractor is paid for the input, while product is still growing and unharvested, or when product has ripened.
E	23	Title to product passes from Farmer to Contractor earlier than the norm--at time of execution of contract or when produce comes into potential existence; or later than the norm--when the Contractor makes payment to Farmer or when Contractor sells the unprocessed product.
F	107	Title to product is either retained by Contractor throughout the production phase, or is passed from Farmer to Contractor when Contractor processes the product and sells it as processed goods.

Category 6. Risk of Loss During Production

An important aspect of vertical coordination contracts is allocation between the parties of risk of loss of the product during the production phase, in case the product is destroyed, damaged, injured, or otherwise reduced in quality. Risk of loss of the product is the only concern of the criteria for this category. Excluded, for example, were risks and uncertainties relative to other aspects of the production process, such as loss of the subject-matter input, debts incurred by the parties of their agents, price fluctuations, uncertainties of acceptance of products, and negligent acts by parties or their agents. Excluded also were legal rules that would allocate risks differently in the absence of contract provisions.

In a sole proprietorship, the farmer assumes the total risk of loss for the product. The typical purchaser from a sole proprietor neither performs nor controls any production activities and has no responsibility for production losses. In establishing the criteria for vertical coordination contracts, it was assumed that, if the Contractor assumes a large portion of management by control or performance, increasing the degree of integration, the Farmer's amount of risk of loss should correspondingly decrease. Likewise, when management assumed by the Contractor increases, the losses for which the Contractor disclaims liability should decrease.

Under contract farming, the degree of integration increases if the Contractor does not assume the risk of loss for the product when he is a partial cause of that loss. A Contractor may cause damage to the product by specifying delivery dates that are too late, suggesting inapplicable pest control measures, specifying in the contract

that he will provide harvesting equipment and labor when in fact he does not provide them, and so on. When the Contractor specifies exact delivery dates, and the Farmer is required to assume the risk of loss because of the product's unexpectedly rapid maturity, integration further increases.

The contracts showed a relatively clear dichotomy, in that some provided that the Contractor accept responsibility for risk of loss consistent with his responsibility under the law and/or his assumption of managerial control, and that some had provisions by which the Contractor disclaimed such responsibility. Evidently, these two incompatible coordination practices existed side by side in some areas of production. In some provisions on risk of loss during production, the dichotomy almost shouted its presence. Yet, at this stage of development of the classification, the authors found no other solution than to recognize that conventional ideas about integration (which are based on a reciprocal transfer of elements of entrepreneurship) exist in a real world, where the level of integration actually increases when a nonreciprocal transfer of elements of entrepreneurship occurs.

An illustration or two should suffice. The typical farmer normally bears the risk of loss for damages to the product caused by pest control measures that he selects. Integration increases, therefore, if the Farmer must bear losses for control measures suggested or performed by the Contractor. If the contract purports to shift the responsibility for acts suggested or performed by the Contractor, the degree of integration between the two firms increases because the Contractor is shifting liability for his own actions to the Farmer. The Farmer continues to bear the risks involved, although he has released to the Contractor the correlative managerial control.

The degree of integration resulting from provisions on risk of loss during production was determined according to these criteria:

Criteria group	Number of contracts	Description
A	25	Farmer bears risk of loss, if damage to product occurs without fault of Contractor.
B	125	Farmer bears risk of loss, if damage to product occurs without fault of Contractor, but Contractor specifically disclaims any responsibility for loss or damage of product from weather or crop failure.
C	65	Both parties in some degree share risk of loss or damage of product without fault; and Contractor assumes some risk of loss of product through too rapid maturity or any condition he generated.
D	53	Contractor assumes part of risk of loss consistent with his assumption of partial management control; or Contractor disclaims liability commensurate with his degree of control for damages to product resulting from activities of his agents, for risk of loss of product until delivery of product is completed, for damages or injuries to product caused from insect- or weed-control measures suggested or performed by Contractor, for damages to product caused by Contractor specifying delivery schedule, for loss or damage to product due to failure to harvest because of inferior quality product, for loss or damage to product due to the Contractor's failure to harvest if conditions are beyond Contractor's control, or for losses from similar causes.
E	141	Contractor assumes risk of loss consistent with his assumption of managerial control; or Contractor disclaims liability proportional to his degree of control for loss or damages to product caused by Contractor's inability to secure extra labor when contract provides Contractor is to secure extra labor, for

Criteria group	Number of contracts	Description
		damages to product caused by failure to use his equipment when contract provides for its use, for loss or damage to product due to Contractor's failure to harvest when contract provided that Contractor is to harvest, or for losses from similar causes.
F	11	Contractor assumes all production risks; or Contractor disclaims corresponding liability for deterioration of product in storage pending final settlement, for mistakes or errors in Contractor's judgment in producing product, for damages to product caused by Contractor's inability to secure extra labor when contract provides Contractor is to secure extra labor, for loss or damages to product caused by use of Contractor's equipment, or for Contractor's failure to use equipment when contract provided for its use, or for losses from similar causes.

Category 7. Restrictions on Farmer[2]

A contract may contain provisions that restrict the Farmer's freedom of choice, particularly in the production and marketing phases of the contract. The number and extent of restrictions created by the contract, from which either a sole proprietorship or a fully integrated firm would be free, was used in the classification as a criterion of the degree of integration.

Express warranties made by the Farmer and special limitations may restrict not only the Farmer's freedom of decision with respect to the contract product, but also other activities while he is producing the contract product. An express warranty may be a positive statement by the Farmer that he will perform certain acts, or it may be a negative promise to refrain from certain activities. In some of the contracts, the Farmer warranted that he would grow the particular product for the Contractor, or that he would sell or offer all of the contract product to the Contractor. A common negative warranty prohibited the Farmer from having marketing agreements with cooperatives.

Special limitations may be placed on the Farmer's activities in contract clauses purporting to delineate the scope of the agreement. A special limitation may be similar in content to a Farmer's express warranty, but it is phrased as a limitation rather than a warranty representation.

In the absence of any restriction in the contract, the Farmer may grow a like product on his own, contract to grow a like product for others, grow a like product for home consumption, sell excess quantities to others, or sell the rejected product to others. A few contracts affirmatively stated some of these rights. Provisions in some of the other contracts denied the Farmer the power to exercise these and other rights. In establishing criteria for use in classifying restrictions on the Farmer, it was assumed that the degree of integration increased as restrictions were placed on the Farmer's rights to produce and market products other than the one produced under the contract.

The criteria developed for this category were as follows:

Criteria group	Number of contracts	Description
A	8	No restrictions are mentioned on noncontract production; only an affirmative commitment is made to produce the specified product.
B	152	Affirmative statement is made in contract of right to grow a like crop or like animals, to contract with others for a like crop or like animals, to sell contract products to others if higher price is offered, to sell unripened, excess, or rejected product, and so on.
C	11	Farmer has right to grow a like product only for home consumption; Farmer has right to sell to others if Contractor lowers price, if Contractor restricts delivery, if product ripens

Criteria group	Number of contracts	Description
		before opening of plant, or if Contractor does not exercise option to buy; Farmer cannot sell or dispose of products grown under contract until first yield has been delivered to Contractor or until exact amount specified in contract has been sold to Contractor.
D	76	Farmer may neither grow, nor contract with others to grow, a like crop or like animals, except that he may grow a like product for home consumption; and Farmer may sell any excess to others only with the Contractor's consent.
E	133	Farmer may not grow a like product for any other purpose; and Farmer may sell rejected product to others only for limited purposes, such as feed.
F	40	Farmer may not sell to anyone other than Contractor any product grown under contract, even though excess or rejected, but may use it for his own feeding purpose.

Marketing the Output--Production Phase 3

Category 8. Marketing Decisions

Marketing decisions relate to control over (1) time of sale and (2) time and place of delivery of the marketable product. A sole proprietor makes marketing decisions according to his estimate of the market and of his unique situation. A contract may contain no specific requirement as to time or place, but may have some provision that implies which party makes the decision. Time of sale or time and place of delivery may be specified in the contract in rather exact terms. If time of sale is not exactly specified, it may be described as within a certain period, when animal is a certain age, when the product is ripe, or immediately after harvesting.

In the progressive degrees of integration, from a sole proprietorship to a fully integrated status, marketing decisions typically would be made by the Farmer, by exact specifications in the contract, by subsequent mutual agreements, or by the Contractor. In establishing criteria by which to measure degree of integration, weight was given to determination of place of delivery if time was principally determined by outside factors. If time was determined by one of the parties and the final time decision could cast a storage burden on the other party, this was taken into account in the criteria. The determination of place of delivery was given weight if it could affect transportation costs. In a sale or bailment contract, place of delivery was a relatively neutral factor, except insofar as it related to costs.

The degree of integration resulting from provisions on time of sale and time and place of delivery was determined by these classification criteria:

Criteria group	Number of contracts	Description
A	1	Farmer decides buyer, and time of sale, and time and place of delivery.
B	34	Farmer decides time of sale and time and place of delivery within reasonable limits in context of the contract; or, if Contractor does not receive the goods, decisions are usually made jointly at market time.
C	67	Contract states time of sale and time or place of delivery to Contractor, and Farmer makes other decisions.
D	102	Contractor and Farmer mutually make time and place decisions, either by exact specifications in contract or subsequent agreement, or one decision is made by Farmer and one by Contractor.
E	143	Contract states either time or place of sale and Contractor decides other.
F	73	Contractor decides both time and place of delivery.

Category 9. Price of Product

A much discussed advantage of contract farming is the reduction, or entire elimination, of the Farmer's uncertainty about

the price he will receive for his product. In fact, forward pricing was a characteristic of some vertical coordination contracts. Some contracts, contrariwise, provided for "delayed pricing," that is, for determining price later than under a typical sole proprietorship operating in an open market. The contracts incorporated numerous mechanisms and formulas to determine the price paid to the Farmer for the product. Some specified in exact amount the price the Farmer was to receive, while others presented complicated formulas so that price determinations could be made at a later date, even after delivery. However, the price the Farmer was to receive for the product, in many instances, was uncertain until delivery, because the basis for many contract formulas was the uncertain and fluctuating market.

The degree of price uncertainty to which the Farmer remains subject could be related inversely to the degree of integration. However, in many contracts, this inverse relationship did not exist. Although a sole proprietor typically accepts the uncertainties of the local market price at the time of delivery, some vertical coordination contracts imposed additional uncertainties on the Farmer; his price sometimes depended on factors other than the local market price at the time of delivery. For example, many seed-production contracts based the Farmer's price on prices at a remote market at a specified future date. Also, in many sugar-beet contracts, the price paid to the Farmer was based on a formula deriving from, among other things, the Contractor's gross or net proceeds in selling the processed product. In a practical sense, price uncertainty increased under some contracts as the degree of integration increased. If a Farmer under contract receives the local market price on a date of his own selection, his position in regard to price hardly differs from a farmer who produces for the open market. As a contract approaches a fully integrated pricing status, the Farmer presumably would be guaranteed a specific price before production was undertaken.

The amount paid to the Farmer in many contracts was based only in part on market price. A combination of market price and one or more other criteria may determine the price; for example, market price may be adjusted according to quality, grade, yield, gain, feed conversion, size of product, variety, date of delivery, number of harvestings, method of harvestings, type of processed product sold, or a combination of two or more of these factors.

In some contracts, a quality provision was incorporated in a gross or net proceed formula. Price per unit of product sometimes was varied to add a factor of time per unit or time and space per unit. In some contracts, the price stated in the contract could be changed prior to the date of delivery. In some of these, the Contractor could adjust, during the production period, the price specified in the contract. In others, the redetermination of price was dependent upon conditions beyond the Contractor's control.

The degree of integration resulting from provisions increasing or decreasing price uncertainty was determined according to these criteria:

Criteria group	Number of contracts	Description
A	11	Local market price at time of delivery.
B	13	Fixed percent over or under local market price at time of delivery; specified remote market price at time of delivery; or Farmer specifies minimum price acceptable for product at time of delivery.
C	13	Fixed percent over, or under, or average remote market price at time of delivery; sliding scale based on market price and quality of product at time of delivery; or fixed price per unit determined from base of local market price at time of delivery.
D	182	Fixed price computed by sliding scale based on gain, feed conversion, grade, yield, number or method of harvestings, size, quality, variety, and so on; or fixed price per unit based upon local market price and sliding scale related to feed conversion, variety, cost of subject-matter input, weight of animals, method of harvesting, grade, volume, season of year, and so on.

Criteria group	Number of contracts	Description
E	142	Fixed price per unit of product (perhaps related to floor space or period of growth); price specified by Contractor after execution of contract, or subject to subsequent adjustment by Contractor within specified limits, or beyond control of Contractor because of market conditions; or price depends on proceeds received by Contractor for unprocessed product.
F	59	Fixed price per unit of product; or maximum uncertainty via price determination by Contractor after contract is signed, particularly where price depends on "net" proceeds received by Contractor after processing the product, in which case the profit motive is integrated through the pricing criterion.

Category 10. Acceptability of Product

A purported advantage of contract farming is that it guarantees the Farmer a market outlet for the specified amount of his product. The Farmer, in a spirit of reciprocity, assures the Contractor of receiving the amount specified in the contract. The degree of integration resulting from the contractual relationship should be in approximately inverse ratio to the degree of typical open-market uncertainty borne by the Farmer.

Several methods are used to specify the amount to be delivered to the Contractor. A contract may state the amount in exact number of bushels, pounds, tons, animals, and so on, or in terms of all products grown on a given number of acres or products from a given number of animals. Some contracts, especially those between a Farmer and a cooperative (as the Contractor), may require the Farmer to deliver all of the particular product grown by him on his premises, until the membership contract is terminated by either party.

A farmer operating without a contract has no guaranteed market outlet for a particular product, although many established markets may exist. As integration increases, the Farmer should be more assured of a market outlet for the product produced under the contract. As a general rule in contract farming, the greater the assurance of a market, the greater the amount of integration. However, the Contractor's rejection rights may decrease the Farmer's market certainty. For example, a contract may require that the product be delivered to the Contractor, thus establishing a single buyer, but it may permit the Contractor to reject the product for general reasons or at the Contractor's own discretion. The greater the degree of discretion which the Contractor can exercise in rejecting the product, the greater is the Farmer's market uncertainty. Thus, a vertical coordination contract may increase, decrease, or have no impact on market uncertainty.

Degree of integration is properly measured, at least in part, by the Contractor's right of rejection. Contracts incorporate many standards for rejecting the products. Some contracts specify the tests in exact terms, while others allow the Contractor substantial discretion in rejecting. Depending on the reasons for rejection, the contract may create serious market uncertainties, much greater uncertainty than exists in a viable open market. When the Contractor has the right to reject the products for very general reasons, the Farmer's position may be precarious indeed.

Criteria for determining the degree of integration resulting from uncertainty of acceptability of product were as follows:

Criteria group	Number of contracts	Description
A	9	Contractor may reject product that fails to meet legal standards of pest control, certification, and so on.
B	100	Contractor may reject product because of failure to meet U.S. Grade Standards or to follow isolation requirements, because of being mixed with other varieties or crops during planting, harvesting, or storage; because infested by pests, or has excess foreign materials; or for similar objective reasons

Criteria group	Number of contracts	Description
		more precise than applicable legal standards.
C	86	Contractor may reject product because of failure to meet specific quality standards set out in contract, because of failure of acceptance by Government inspectors, because delivery was made after termination of season, because product was excess in acreage or amount, or for like reasons objectively determinable and more precise than extant law.
D	142	Contractor allowed greater discretion to reject product because of failure to meet quality standards, because a portion is infested by pests or has excess foreign materials, because a portion does not meet specific standards, or because excess foreign materials cannot be removed without great expense, or Contractor may reject a pro rata share of each Farmer's product if production exceeds processing capacity.
E	45	Contractor may reject product because of inability to process, because product can not be profitably harvested or processed, because of failure to meet quality standards of Contractor or trade association, or Contractor also may reject product for failure to perform production activities at proper time, for failure to deliver product as instructed, or for failure to abide by provisions of the contract.
F	38	Contractor may reject product at his discretion or if delivery is made after a date set by Contractor; or if the quantity available is insufficient for operation of Contractor's plant; or for other reasons within Contractor's determination which cannot be influenced by Farmer.

Scoring of Contract Provisions

Symbols of 0 to 5 were used for ease in scoring contract provisions according to the above criteria. Zero represented a contract element which was so close to the sole-proprietorship norm as to involve no measurable or significant transfer of entrepreneurship. Five represented approximately total integration. A contract whose provisions regarding subject-matter input decisions corresponded to provisions under criteria group A for the input decisions category scored 0 integration points under that category. If the contract's provisions corresponded to provisions under criteria group B, the score was 1 integration point, and so on, with group F scoring 5. The aggregate of the degrees of integration of the 10 separate categories of contract elements was the measure of the overall degree of integration of each contract. If any contract had scored either 0 or 5 in all 10 categories, it should not have been included in the sample, for an aggregate score of 0 would have meant no integration had taken place, and a score of 50 would have meant total integration.

DEGREE OF TRANSFER OF ENTREPRENEURSHIP

The preceding section presented the first classification scheme for measuring the shift of entrepreneurship from the Farmer to the Contractor in sample vertical coordination contracts. The application of the classification scheme to the 420 contracts, which is the subject of this section, illuminated the transfer of entrepreneurship under contract farming. The section presents (1) an analysis of the least and most highly integrated contracts for purpose of comparison and contrast, (2) a relatively close examination of the much-discussed broiler contracts, (3) geographic and commodity differences among contracts, (4) the result of application of the classifications scheme to all contracts, and (5) ideas that may be valuable in future research and experimentation.

Analysis of the Least and Most Integrated Contracts

The actual range in aggregate scores for the sample contracts was from 12 to 43 integration points, with only one contract at each extreme. Two contracts had an overall score of 13 and three scored 42. The integration points scored in each classification by these seven contracts are summarized in table 1.

The three contracts with only a slight transfer of entrepreneurship represented three different commodities, each from widely separate parts of the country and each used by a different Contractor. All three were basically future purchase agreements, as contrasted with agreements to supply inputs; they all scored zero on the integration criteria under the input phase. The contracts were short--1 page or a single paragraph--in comparison with those contracts providing a high degree of coordination.

These three contracts were only slightly concerned with the production phase of the Farmer's operations. The general livestock contract placed no restrictions on the Farmer in producing livestock; the small grain seed contract prohibited production of similar small grain in nearby fields. Ownership of the product was maintained by the Farmer, and ownership passed to the Contractor upon delivery, according to established legal rules. The Farmer owned the subject-matter input and the product during the production process.

Specifications regarding the three marketing categories (marketing decisions, price of product, and acceptability of product) varied in relation to the importance of marketing control to the Contractor. The marketing of small grain seed was not tightly controlled, while the marketing requirements for wine grapes and for livestock were quite specific. The provisions regarding marketing decisions showed a greater transfer of entrepreneurship than provisions regarding either price or acceptability of product. The price to be paid the Farmer was specified in the livestock and grape contracts, but in the small grain contract the price was based on quotations at local grain elevators, plus a stipulated bonus--essentially an open-market price determination. None of the Contractors guaranteed acceptance of all of the commodity delivered, but the exceptions were slight. In sharp contrast to these contracts were four contracts involving the production of hybrid seed corn, pullets from chicks, and broilers, all providing for a high degree of integration.

Table 1. Degree of integration of vertical coordination contracts, with the lowest and highest integration points, by classification criteria

Commodities	Acquiring the input		Producing the commodity					Marketing the output			Degree of integration
	Subject-matter input decisions	Ownership and risk of loss of inputs	Production decisions	Standards of husbandry	Ownership during production	Risk of loss during production	Restrictions on Farmer	Marketing decisions	Price of product	Acceptability of product	
	Integration points										
Livestock, general....	0	0	1	1	1	1	0	3	4	1	12
Grapes, wine.....	0	0	1	1	1	0	1	4	4	1	13
Small grain, general..	0	0	1	2	1	1	4	2	0	2	13
Hybrid seed corn.....	5	5	4	4	5	4	4	4	3	5	43
Hybrid seed corn.....	3	4	4	4	5	4	5	4	4	5	42
Pullets from chicks...	4	5	4	4	5	4	5	5	5	1	42
Broilers.....	5	4	5	4	5	4	4	5	5	1	42

All scores were either 4 or 5 on decisions regarding the inputs, except for one of the hybrid seed corn contracts which was unclear as to either the source or particular variety of seed to be used. All four contracts scored the same for standards of husbandry, ownership during production, and risk of loss during production. The Contractor maintained full ownership of product during the production phase (5 points), and he never relinquished ownership unless at time of delivery the product was unacceptable. The degree of control over standards of husbandry and responsibility for loss of the product was not complete, yet integration was substantial.

The complete and exclusive right to reject any or all of the product was reserved in the two hybrid seed corn contracts, while the Contractors accepted all broilers and pullets under these two contracts about as if it were an open market transaction. Contractors have a high degree of certainty as to the end product for broilers and pullets, but hybrid seed could become unsalable as seed corn.

The foregoing discussion was in terms of individual contracts. In addition, a comparison was made between average integration points scored by contracts achieving the greatest and those achieving the least integration. Averages are shown in table 2 for the 16 contracts with scores of 15 or lower and for the 15 with scores of 40 or higher.

The average integration points for the 16 low-scoring contracts exhibited little transfer of decision making from Farmer to Contractor regarding the subject-matter input, showed a slight increase in Contractor's control and responsibility over the production phase, and indicated the greatest shift in entrepreneurship to the Contractor in the marketing phase. For the low-scoring contracts, the average coordination points were as follows: 0.8 for input, 1.2 for production, and 2.1 for marketing.

The high-scoring contracts showed about the same degree of control by the Contractor for the input and production phases and slightly less transfer to the Contractor in the marketing phase--the averages were 4.1, 4.3, and 3.8 points, respectively.

Table 2. Average degree of integration for selected vertical coordination contracts, by classification criteria

Phase of production	Integration--	
	15 or lower[1]	40 or more[2]
	Integration points	
Acquiring the input:		
Subject-matter input decisions	0.9	3.9
Ownership and risk of loss of inputs	0.8	4.3
Producing the commodity:		
Production decisions	0.9	4.2
Standards of husbandry	1.8	4.1
Ownership during production	1.0	5.0
Risk of loss during production	0.9	4.1
Restrictions on Farmer	1.6	4.1
Marketing the output:		
Marketing decisions	2.4	4.5
Price of product	2.5	3.7
Acceptability of product	1.5	3.1
Degree of integration (total)	14.3	41.0

[1] Averages derived from 16 contracts.
[2] Averages derived from 15 contracts.

Results of Classification of Broiler Contracts

Contract farming in the broiler industry has created much discussion and resulted in much research in recent years. It is not surprising, therefore, that the broiler industry was represented by a larger number of contracts (42) than any other product.

The range in total integration points for broiler contracts was from 21 to 42 (table 3). According to this measure, some broiler contracts transferred twice as much entrepreneurship to the Contractor as did others.

Broiler contracts showed an average degree of integration of 31.1 points, or an average score of 3.1 for the 10 classification criteria. With notable exceptions in individual cases, broiler contracts departed from the sole proprietorship open market situation less in regard to decisions about acceptability of final product (1.9), restrictions on Farmer (2.0), and production decisions (2.4) than in regard to marketing decisions (4.5) and ownership and risk of loss of the subject-matter input 3.7).

The low degree of integration in acceptability of the final product, averaging 1.9 integration points, was due in large part to the fact that the highly standardized subject-matter input was largely under the control of the Contractor. The rather high degree of integration of standards of husbandry--2.8 integration points--also helps to explain the low score on acceptability of product. Contractor control over inputs and standards of husbandry (often accompanied by a premium for low feed conversion ratio) can be expected to result in an acceptable end product.

Marketing decisions, involving principally time and place of delivery of the broilers, were usually almost completely at the discretion of the Contractor. The average integration score in this category was 4.5. In the typical cases, either the time or place of delivery was specified in the contract, with the Contractor to determine the other at a later time. Time of delivery is important in broiler contracts because of the need to maintain an even flow of broilers through the processing plant.

The Contractor maintains ownership of the subject-matter input and of the product during production to safeguard his investment, not only in the subject-matter input, but also in other inputs, such as feed and medicine supplied during the production phase.

The relatively high scores of the broiler contracts in certain integration categories (subject-matter input decisions, 3.6 points; ownership of product during production, 3.6; and price of product, 3.6) reflect the Contractor's desire to maintain a strong security interest in his input and the Farmer's desire to shift to the Contractor the pricing vagaries of the market place. If the contract provided that the chicks must be purchased from a third party, the relationship between the Farmer and the third party could be ambiguous as to quality, price, security device, and time and method of payment, and the Farmer could find himself in a more vulnerable position than if he were free to buy from any dealer in the open market.

Integration scores for broiler contracts varied greatly, but differences among geographic areas were not generally significant for these contracts. This finding supports the idea that classification of contracts by commodities probably leaves much to be desired.

Geographic and Commodity Differences for All Contracts

Analysis of the total sample of 420 contracts on the basis of 5 geographic areas revealed that variation in average integration points between north and south and east and west appeared to be negligible, but the nature of the sample did not permit a definitive conclusion (table 4).

Analysis by commodities was more revealing. Each of 7 commodities was represented by 15 or more different contracts, a number large enough to permit comparisons between commodity groups. The 420 contracts were also divided into 3 major commodity groups for additional comparisons. Average degrees of integration are summarized in table 5.

According to the integration scores, the hybrid seed corn contracts, with an average score of 34.8 integration points, were most integrated, and the commercial egg contracts, with an average score of 23.6, were least integrated. Contracts for each of the seven commodities listed in table 5, except the commercial eggs and tomato contracts, averaged higher scores than the average score for all contracts.

A comparison of average scores of contracts in the three commodity groups shows that the livestock contracts provided for

Table 3. Degree of vertical integration provided for in broiler contracts

Geographic area, contract symbol	Acquiring the input		Producing the commodity					Marketing the output			Degree of integration
	Subject-matter input decisions	Ownership and risk of loss of inputs	Production decisions	Standards of husbandry	Ownership during production	Risk of loss during production	Restrictions on Farmer	Marketing decisions	Price of product	Acceptability of product	
	Integration points										
Western:											
C-22	4	5	4	4	5	4	1	5	3	5	40
C-23	2	4	1	2	5	4	4	5	4	1	32
North Atlantic:											
E-5	4	5	4	4	5	4	4	5	2	1	38
North Central:											
T-2	4	4	3	3	5	4	3	5	3	1	35
S-3	4	4	4	4	5	4	1	5	3	5	39
S-4	4	4	4	4	1	1	2	5	5	1	31
S-5	4	4	4	4	1	1	2	3	3	1	27
L-1	2	2	4	4	1	2	1	1	5	1	23
L-2	2	2	4	4	1	2	1	1	5	1	23
M-2	4	5	4	4	5	4	1	3	2	1	33
M-3	3	4	4	4	5	4	0	5	4	5	38
A-4	3	2	3	3	1	1	4	1	2	1	21
South Atlantic:											
M-4	5	4	3	4	5	1	3	5	4	1	35
S-33	2	2	3	3	1	0	3	4	3	1	22
R-2	2	5	4	4	5	2	0	5	5	1	33
S-28	4	4	0	2	5	4	4	5	2	1	31
C-27	5	4	4	4	5	4	1	5	3	1	36
T-1	4	4	0	2	5	4	3	5	3	1	31
S-31	5	5	1	1	5	4	3	5	5	1	35
South Central:											
H-13	2	4	3	3	5	4	1	5	5	1	33
V-3	5	2	4	4	1	0	1	5	3	1	26
C-5	4	4	0	2	5	4	3	5	3	5	35
C-13	4	4	0	2	5	4	3	5	5	5	37
C-14	4	4	0	2	5	4	3	5	5	1	33
C-15	4	4	0	2	5	4	3	3	2	1	28
C-16	4	4	0	2	5	4	3	5	3	1	31
C-17	4	4	0	2	5	4	3	5	2	1	30
N-8	4	5	3	3	5	4	3	5	3	1	36
E-3	5	4	5	4	5	4	4	5	5	1	42
E-4	5	4	5	4	5	4	4	5	3	1	40
D-3	4	4	1	2	5	4	1	5	3	1	30
B-4	4	4	4	4	5	4	1	5	2	3	36
P-3	4	4	1	1	1	2	1	3	4	3	24
P-4	2	2	1	1	1	2	1	3	5	3	21
P-5	2	2	1	1	1	2	1	5	5	3	23
P-6	4	4	1	1	1	2	1	5	4	3	26
P-7	4	4	1	1	1	2	1	5	3	3	25
P-8	2	2	1	1	1	2	1	5	5	3	23
P-9	5	4	5	4	1	0	1	5	4	3	32
P-11	4	4	5	4	5	4	1	5	4	1	37
D-4	2	4	1	3	5	4	1	5	5	1	31
G-3	2	3	1	1	1	3	1	5	2	3	22
Averages											
Western	3.0	4.5	2.5	3.0	5.0	4.0	2.5	5.0	3.5	3.0	36.0
North Atlantic	4.0	5.0	4.0	4.0	5.0	4.0	4.0	5.0	2.0	1.0	38.0
North Central	3.3	3.4	3.8	3.8	2.8	2.6	1.7	3.2	3.6	1.9	30.0
South Atlantic	3.9	4.0	2.1	2.9	4.4	2.7	2.4	4.9	3.6	1.0	31.9
South Central	3.7	3.7	1.9	2.3	3.4	3.1	1.9	4.7	3.7	2.1	30.5
Total	3.6	3.7	2.4	2.8	3.6	3.0	2.0	4.5	3.6	1.9	31.1

Table 4. Average integration scores of sample contracts, by geographic area

Geographic area	Number of contracts	Average integration scores
North Atlantic..	59	25.0
South Atlantic..	42	25.3
North Central...	166	27.8
South Central...	81	27.4
Western.....	72	27.9
All contracts.	420	27.2

the greatest integration, scoring 29.1 integration points, followed by contracts for producing seeds, with a score 27.7, and contracts for producing fruits, vegetables, nuts, and crops, with a score of 26.3. However, the differences were not great, a spread of less than 3.0 integration points.

Comparisons Among All Contracts

Differences and similarities were observed among selected groups of contracts. Most degree-of-integration scores for individual contracts, 299 out of 420, fell between the scores of 20 and 35 integration points (fig. 1). The average was 27.2 points. Generally, slightly more than one-half of entrepreneurship was transferred to the Contractor, as measured by the experimental classification scores.

The contracts, on the average, showed a higher degree of integration in the pricing and marketing-decisions categories than in any other categories, with integration scores averaging 3.4 and 3.3, respectively (table 6). Farmers under these contracts transferred to Contractors, on the average, about two-thirds of entrepreneurial control over marketing decisions, and the Contractor assumed, on the average, about two-thirds of the uncertainty of the product's future price.

Judging from integration scores, farmers are not averse to producing to specifications and to maintaining rigid production standards for a price consideration. Many vertical coordination contracts either provided detailed specifications for products that would be accepted, or left acceptance decisions to the Contractor at time of delivery. Note the high scores on Contractor's control over acceptability of product for hybrid seed corn, green and wax beans, peas, sweet corn, and the total of fruits, vegetables, nuts, and crops (table 6).

The average scores of the contracts seem to show that the Contractor tends to exert approximately equal control over input and production decisions, and standards of husbandry. However these averages mask substantial differences within individual contracts. For example, the livestock contracts scored only 1.7 average

Table 5. Average degree of integration of sample contracts for commodities having 15 or more contracts, and for 3 major groups of commodities

Commodities	Number of contracts	Acquiring the input		Producing the commodity					Marketing the output			Degree of integration[1]
		Subject-matter input decisions	Ownership and risk of loss of inputs	Production decisions	Standards of husbandry	Ownership during production	Risk of loss during production	Restrictions on Farmer	Marketing decisions	Price of product	Acceptability of product	
		Integration points										
Commodity:												
Hybrid seed corn.....	17	3.1	4.1	3.6	3.5	4.1	3.6	3.5	3.6	2.5	3.3	34.8
Sweet corn.....	31	2.6	3.0	3.6	2.9	1.9	3.5	2.0	3.6	3.8	3.2	30.1
Peas.....	33	3.0	3.0	3.4	3.3	1.8	3.2	2.3	3.5	3.1	3.0	29.6
Green and wax beans.....	24	2.5	3.2	2.9	3.3	1.6	2.5	3.2	3.0	3.5	3.0	28.8
Broilers.....	42	3.6	3.7	2.4	2.8	3.6	3.0	2.0	4.5	3.6	1.9	31.1
Tomatoes.....	40	2.5	2.5	1.4	2.3	1.6	1.7	3.7	2.8	3.4	2.9	24.8
Commercial eggs.....	15	1.7	1.7	2.2	2.9	2.3	2.0	3.3	2.7	2.9	1.9	23.6
Commodity group:												
Livestock, poultry, and eggs.....	92	3.0	3.2	2.7	2.9	3.1	2.8	2.4	3.6	3.5	1.7	29.1
Seeds.....	68	2.8	3.3	2.3	2.6	2.9	2.8	2.9	3.0	2.7	2.4	27.7
Fruits, vegetables, nuts, and crops.	260	2.3	2.4	2.5	2.7	1.7	2.3	2.8	3.3	3.6	2.9	26.3
All contracts.....	420	2.5	2.7	2.5	2.7	2.2	2.5	2.7	3.3	3.4	2.5	27.2

[1] Average scores for each criterion not rounded, so may not add to totals.

Table 6. Average degree of integration of 420 vertical coordination contracts, by commodities

Commodities	Number of contracts	Acquiring the input		Producing the commodity					Marketing the output			Degree of integration[1]
		Subject-matter input decisions	Ownership and risk of loss of inputs	Production decisions	Standards of husbandry	Ownership during production	Risk of loss during production	Restrictions on Farmer	Marketing decisions	Price of product	Acceptability of product	
		Integration points										
Livestock, poultry, and eggs												
Broilers	42	3.6	3.7	2.4	2.8	3.6	3.0	2.0	4.5	3.6	1.9	31.1
Commercial eggs	15	1.7	1.7	2.2	2.9	2.3	2.0	3.3	2.7	2.9	1.9	23.6
Feeder pig production	1	1.0	0.0	4.0	4.0	1.0	1.0	4.0	3.0	1.0	2.0	21.0
Hatching eggs	10	3.1	3.7	3.5	3.4	2.1	3.3	2.7	3.0	3.4	1.7	29.9
Laying hens from chicks	3	2.3	2.7	2.0	2.7	2.3	1.3	1.0	1.0	3.0	1.0	19.3
Livestock, general	3	1.0	1.3	1.7	2.0	2.3	2.7	2.3	3.0	4.0	2.3	22.7
Market hogs from feeder pigs	2	3.0	3.0	3.0	3.5	3.0	3.0	2.5	2.5	3.5	1.0	28.0
Market hogs from gilts and boars	3	2.3	3.0	2.7	2.7	2.0	2.0	2.7	3.7	2.0	2.3	25.3
Market lambs from feeder lambs	1	4.0	4.0	3.0	2.0	5.0	4.0	4.0	5.0	3.0	1.0	35.0
Pullets from chicks	5	4.0	4.2	4.0	3.4	5.0	4.0	3.8	4.2	5.0	1.4	39.0
Turkeys	7	3.0	3.7	3.3	3.1	3.7	3.0	2.0	2.9	4.4	1.0	30.1
Subtotal	92	3.0	3.2	2.7	2.9	3.1	2.8	2.4	3.6	3.5	1.7	29.1
Seeds												
Barley	1	3.0	4.0	3.0	2.0	5.0	4.0	4.0	4.0	4.0	2.0	35.0
Beans	2	3.5	2.5	2.5	3.0	1.0	1.0	3.0	3.5	2.5	1.0	23.5
Cotton	3	3.0	3.3	2.3	2.0	2.3	2.3	3.0	2.7	1.0	3.0	25.0
Flowers, general	2	2.5	3.0	1.0	2.5	3.0	2.5	2.0	2.5	2.5	2.0	23.5
Grass, general	1	1.0	1.0	3.0	1.0	1.0	5.0	3.0	4.0	5.0	1.0	25.0
Hybrid corn	17	3.1	4.1	3.6	3.5	4.1	3.6	3.5	3.6	2.5	3.3	34.8
Hybrid sorghum	3	2.3	3.3	3.0	2.3	3.0	3.3	2.3	3.7	3.3	2.7	29.3
Hybrid sweet corn	1	3.0	4.0	3.0	3.0	5.0	4.0	4.0	4.0	3.0	2.0	35.0
Mung beans and cowpeas	1	1.0	1.0	3.0	1.0	1.0	1.0	3.0	4.0	4.0	2.0	21.0
Oats	6	2.8	3.2	1.7	2.3	2.3	2.2	2.7	2.8	3.2	2.3	25.5
Peas	1	3.0	4.0	0.0	4.0	5.0	4.0	4.0	3.0	5.0	3.0	35.0
Rye	1	3.0	3.0	1.0	2.0	1.0	2.0	1.0	2.0	0.0	5.0	20.0
Seeds, general	1	3.0	4.0	1.0	2.0	5.0	4.0	4.0	3.0	3.0	3.0	32.0
Small grain, general	7	2.1	2.1	2.0	2.6	1.0	1.3	2.6	2.7	1.4	1.0	18.9
Small grain, general, and grass	4	2.8	2.8	1.8	2.8	2.0	2.3	2.0	2.5	3.8	1.5	24.3
Small grain, general, and soybeans	2	3.0	2.5	1.0	2.0	1.0	3.0	1.0	2.5	0.5	1.5	18.0
Soybeans	2	2.5	2.5	2.0	2.0	1.0	1.5	2.0	3.5	1.5	1.0	19.5
Vegetables, general	9	3.1	3.8	1.7	2.2	4.1	3.6	3.0	2.2	3.9	2.8	30.4
Vegetables, lawn and flowers, general	1	2.0	4.0	1.0	2.0	5.0	4.0	3.0	2.0	5.0	5.0	33.0
Watermelon	1	4.0	4.0	4.0	4.0	5.0	4.0	4.0	4.0	4.0	1.0	38.0
Wheat	2	3.0	3.0	1.0	2.0	1.0	0.0	2.0	1.5	2.0	1.0	16.5
Subtotal	68	2.8	3.3	2.3	2.6	2.9	2.8	2.9	3.0	2.7	2.4	27.7
Fruits, vegetables, nuts, and crops												
Apples	5	0.2	0.0	1.8	1.8	1.0	1.0	2.2	3.6	3.0	2.6	17.2
Asparagus	2	0.5	0.0	2.5	2.0	1.0	2.0	3.5	2.5	4.0	2.5	20.5
Beets	9	2.2	3.0	3.4	2.8	1.8	2.6	1.4	3.6	3.3	2.4	26.6
Blueberries	1	0.0	0.0	1.0	1.0	1.0	1.0	3.0	1.0	5.0	5.0	18.0
Cabbage	10	1.8	2.0	1.4	2.5	1.2	1.4	2.4	3.9	3.8	2.5	22.9
Carrots	7	2.3	2.6	3.3	3.0	1.4	3.0	2.3	3.7	3.6	2.7	27.9
Celery	1	1.0	1.0	3.0	2.0	1.0	2.0	2.0	4.0	3.0	2.0	21.0
Citrus fruit, general	5	0.6	0.0	1.8	2.6	2.0	1.8	4.0	3.2	4.4	2.4	22.8
Cherries	2	1.0	0.0	1.0	1.0	4.0	2.0	4.0	4.5	5.0	4.0	26.5
Cranberries	1	1.0	0.0	1.0	1.0	2.0	1.0	4.0	1.0	5.0	1.0	17.0
Cucumbers	13	2.8	3.2	2.2	2.5	1.8	1.8	2.9	3.2	3.5	3.8	27.9
Dried fruit, general	1	0.0	0.0	1.0	2.0	4.0	2.0	1.0	3.0	4.0	3.0	20.0
Ensilage for livestock	1	2.0	3.0	3.0	3.0	1.0	2.0	3.0	3.0	4.0	5.0	29.0

Table 6. Average degree of integration of 420 vertical coordination contracts, by commodities--Con.

Commodities	Number of contracts	Acquiring the input		Producing the commodity					Marketing the output			Degree of integration[1]
		Subject-matter input decisions	Ownership and risk of loss of inputs	Production decisions	Standards of husbandry	Ownership during production	Risk of loss during production	Restrictions on Farmer	Marketing decisions	Price of product	Acceptability of product	
		Integration points										
Fruits, vegetables, nuts, and crops--Con.												
Fruits, general, kind inserted on contract	2	1.0	0.0	2.0	2.5	2.5	1.0	4.0	4.5	5.0	1.0	23.5
Fruits and vegetables, general, kind inserted on contract	5	1.4	1.8	2.4	2.2	2.8	1.6	2.8	4.2	4.2	2.6	26.0
Fruits, vegetables and nuts, general	1	0.0	0.0	1.0	1.0	4.0	1.0	4.0	1.0	5.0	1.0	18.0
Grapes	4	0.5	0.3	2.0	1.8	1.0	2.0	3.0	3.7	4.0	2.5	20.8
Grapes, wine	4	0.0	0.0	1.0	1.3	2.5	1.3	1.8	4.0	3.5	2.5	17.8
Green and wax beans	24	2.5	3.2	2.9	3.3	1.6	2.5	3.2	3.0	3.5	3.0	28.8
Lima beans	5	3.6	3.4	4.2	3.6	2.4	3.8	1.8	3.2	3.2	2.2	31.4
Okra	2	2.0	2.5	1.0	1.0	1.0	0.5	1.0	3.0	4.0	3.0	19.0
Olives	1	0.0	0.0	1.0	1.0	4.0	2.0	3.0	3.0	3.0	3.0	20.0
Onions	1	2.0	3.0	4.0	2.0	1.0	0.0	3.0	4.0	4.0	4.0	27.0
Peas	33	3.0	3.0	3.4	3.3	1.8	3.2	2.3	3.5	3.1	3.0	29.6
Peppers	5	1.8	2.2	1.0	1.8	1.0	1.8	4.6	3.6	3.6	2.8	24.2
Popcorn	2	2.0	3.5	0.5	2.0	3.0	3.0	1.0	4.0	4.0	2.5	25.5
Potatoes	8	1.3	0.9	3.5	3.6	1.4	1.8	3.0	3.9	3.4	3.0	25.6
Prunes	2	0.5	0.0	1.0	2.5	2.0	1.0	3.0	3.0	4.0	2.0	19.0
Pumpkins	3	3.3	3.7	4.0	4.0	1.0	1.3	2.0	4.7	4.0	2.7	30.7
Rice	1	1.0	0.0	1.0	3.0	1.0	1.0	4.0	2.0	1.0	1.0	15.0
Spinach	1	2.0	3.0	1.0	2.0	1.0	1.0	1.0	4.0	4.0	2.0	21.0
Squash	2	2.0	1.5	1.0	2.0	1.0	1.0	3.0	3.0	4.0	2.5	21.0
Sugar beets	6	3.8	2.5	2.8	2.5	1.0	3.1	2.5	4.5	5.0	3.0	30.8
Sweet corn	31	2.6	3.0	3.6	2.9	1.9	3.5	2.0	3.6	3.8	3.2	30.1
Sweet potatoes	1	1.0	0.0	1.0	2.0	1.0	1.0	4.0	1.0	5.0	4.0	20.0
Tomatoes	40	2.5	2.5	1.4	2.3	1.6	1.7	3.7	2.8	3.4	2.9	24.8
Vegetables, general, kind inserted on contract	6	3.0	2.7	2.7	2.5	1.0	1.5	2.2	2.7	3.8	1.5	23.5
Vegetables, general, more than one specific kind printed on contract.	11	2.5	2.4	2.4	3.0	2.0	1.4	3.3	3.2	3.7	3.1	26.8
Yams	1	1.0	1.0	1.0	2.0	1.0	1.0	1.0	3.0	4.0	2.0	17.0
Subtotal	260	2.3	2.4	2.5	2.7	1.7	2.3	2.8	3.3	3.6	2.9	26.3
Grand total	420	2.5	2.7	2.5	2.7	2.2	2.5	2.7	3.3	3.4	2.5	27.2

[1] Average scores for each criterion not rounded, so may not add to totals.

integration points in the acceptability-of-product category, but in the categories of production decisions, standards of husbandry, and input decisions scored 2.7, 2.9, and 3.0 average integration points, respectively. Averages for the three commodity groups (table 6) also showed an inverse relationship between the degree of Contractor control over subject-matter input decisions and control over acceptability of the product.

Regardless of final evaluation of the classification criteria and of the measures of quantity of entrepreneurship transferred, the average score for all contracts studied, 27.2 points on a 0 to 50 scale, seems to represent a substantial relinquishment of entrepreneurship by the Farmer. When a group of contracts for producing a specific commodity averages as much as 34.8 points, as was true of hybrid seed corn contracts, one may conclude that contract farming in this field involves transfer of a substantial proportion of the entrepreneurship function from the Farmer to the Contractor.

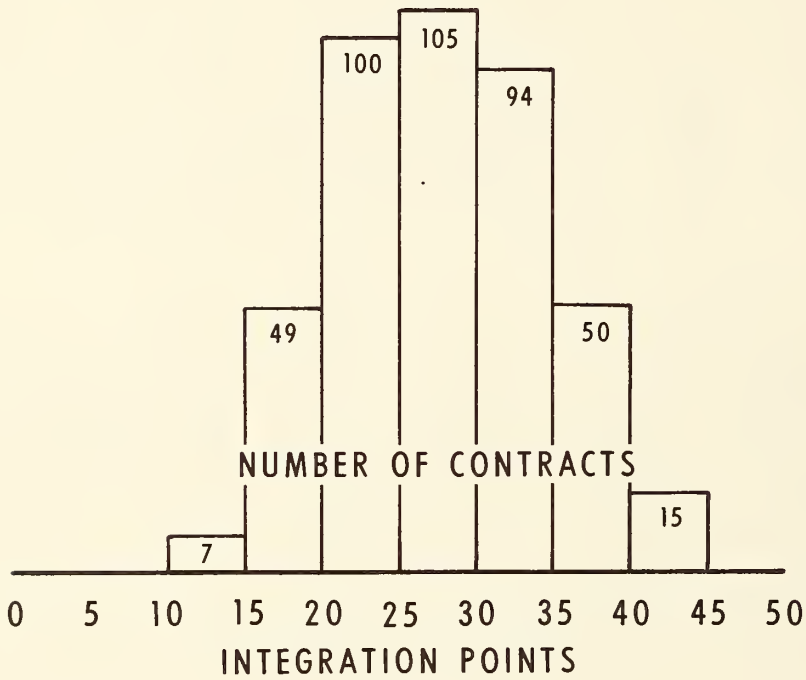

Figure 1

CRITIQUE AND REVISION OF CLASSIFICATION SYSTEM

This section is a preliminary critique of the initial classification system. During the development of the system, the technique of classification was re-examined and the premises were refined, but it became necessary to continue the system despite certain conflicts of ideas and questions about precision of measurement. A completed and applied scheme seemed the most satisfactory base for review and reappraisal.

This section is in part an analysis by the researchers who served throughout the project. In addition, interested colleagues provided substantial assistance. In particular, in their own evaluation the authors drew on Gene Wunderlich's statistical analysis. The authors hope that this section is only the first step in analysis and evaluation and that other scholars will offer further criticism and study.

Statistical Analysis

Analysis of variance, Guttman's coefficient of reproducibility, and factor analysis were the statistical techniques used by Wunderlich in his evaluation of the classification scheme.

The analysis of variance test showed that the differences in mean integration points scored by the various commodity contracts were unlikely to have occurred by chance. Neither the analysis of variance nor the multiple-range test that accompanied it, of course, told anything of the reasonableness or usefulness of the classification scheme. These tests only sought to indicate if the classes differed statistically.

The Guttman scalogram and coefficient of reproducibility indicated that the provisions or groups of provisions might be scalable, but that the contracts as a whole should be analyzed multidimensionally.

Factor analysis, however, led to a specific suggestion that the 10 categories into which contract provisions were grouped in the classification be reduced to 4 involving (1) input supply, (2) production decisions, (3) risk, uncertainty, and liability during production, and (4) risk, uncertainty, and variability associated with the completed product.

Revision of Categories of Contract Provisions

The direction of the revision suggested by the statistical analysis was mainly toward simplification, not substantive change. On the basis of Wunderlich's analysis and the conclusions reached in their own reappraisal, the authors developed a tentative revised set of six categories of contract provisions: (1) input decisions, (2) operational decisions, (3) risk of loss of product, (4) uncertainty of price, (5) uncertainty of market, (6) restrictions on farmer. This new grouping of provisions involved the following changes in the 10 original categories of contract provisions.

Ownership and risk of loss of inputs was eliminated as an independent category of contract provisions. Ownership provisions could be fitted into the category of input decisions, and provisions regarding loss of input tended to be encompassed by the category dealing with risk of loss of product.

The similarity of categories covering production decisions (old category 3) and standards of husbandry (old category 4) was indicated both by the factor analysis and by the reevaluation by the authors. These categories represented two aspects of a single complex of production practices. Also, contract provisions setting standards of husbandry were often in language too vague to permit sharp delineation of degree. These two categories, it was decided, should be combined under the new category 2, operational decisions.

The third new category, entitled "risk of loss of product," covered all aspects of ownership of product and risk of loss during production. The factor analysis indicated the possibility of clustering provisions related to risk, uncertainty, and liabilities in the production process. Because risk and uncertainty were often, in the contracts studied, allocated between the parties without regard to the technical assignment of title to the product, it seemed reasonable that ownership should be included. The factor analysis further drew attention to the fact that provisions regarding risk of loss related to time of delivery (included in old category 8) were broadly related to risk of loss during production. These provisions, it was decided, should also be included under the new grouping.

The category covering provisions regarding restrictions on the Farmer (category 7) was retained as a separate category. The purpose of this category was to determine the degree to which contracts limited the Farmer's freedom of action in the use or allocation of resources not involved in contract production. Practically, it accomplished that purpose, although some difficulty is involved in the implied premise that degree of integration increases as control over the Farmer's noncontract activities increases.

The authors also retained the old categories covering provisions dealing with decisions about prices and acceptability of product as new categories 4 and 5 under the titles "uncertainty of price" and "uncertainty of market." These two provisions were combined in Wunderlich's suggested grouping under "risk, uncertainty, and variability associated with the completed product."

Revision of the Gradation Scale

Reducing the number of categories under which contract provisions were grouped required development of a modified set of statements, a new gradation scale, against which the contract provisions in each category could be measured.

Modification of these categories was also suggested by actual experience with the classification system. In testing contract provisions of the contracts studied against the statements used to measure the degree of transfer of entrepreneurship involved, the authors noted that an apparent conflict in their views of integration had not been fully resolved in the classification scheme.

One view (of integration) holds that integration increases as elements of entrepreneurship are shifted from the Farmer to the Contractor chiefly through assumption of management control and decision making. Implicit in this view is a corollary assumption that increased integration results in increased assumption of risk and uncertainty by the Contractor and increased certainty of price and market for the Farmer. Under another view, however, integration reaches its height when the Contractor has all the management control and decision making and the Farmer bears all the risks and uncertainties. That is to say, integration reaches the maximum when the Farmer loses all rights but none of the burdens in the transfer of entrepreneurship. The "toughest" or "tightest" contract from this viewpoint represents the highest degree of integration.

The necessity of choosing between these views in setting up a gradation scale was not fully understood until the system was used to classify actual contract forms. This was in turn due to a failure to anticipate that the contracts would show a tendency on the part of Contractors to seek benefits and avoid burdens. In fact, many vertical coordination contracts studied placed a large measure of control in the Contractor and left many risks and uncertainties on the Farmer. It was not uncommon for a contract to require that the Farmer follow the precise instructions of the Contractor's fieldman, while the Contractor disclaimed liability not only for the results of the instructions but for any act or omission on the part of the Contractor's personnel.

This presented a problem of how, in a classification system, to take into consideration the two views of integration. A tentative solution was to set up a method of scaling in which relationships could vary from the sole proprietorship norm in two directions. The sole proprietorship situation was visualized as being at the center of a continuum along which transfer of entrepreneurship achieved by contract provisions in each category could be plotted. If a contract provided for increased assumption of risk and uncertainty by the Contractor and increased certainty of price and market for the Farmer as integration increased, the contract's provisions in each category would be plotted on the scale to the right of the sole proprietorship center point. If, with increased integration, the contract placed the Farmer in a state of entrepreneurial disequilibrium by transferring management control without transferring a commensurate quantum of risk-bearing, the contract's provisions would be plotted to the left of the center point. This method of scaling is shown in table 7.

Implicit in this scheme of classification is the mutually exclusive quality of each group: A contract cannot be classified as following both the classical and tight contract views. The burden falls upon the examiner of the contract to determine whether the combination of classification criteria found in the contract is "more like" the classical or the tight-contract view. The task of interpreting contractual provisions and assigning them to a classification is by no means unique or uncommon, at least to the legal profession. The discussion in chapter 4, Relationships and Responsibilities, indicates how important and frequent such classification is in legal analysis. There was no hybrid or middle ground between "employee" and "independent contractor;" the examiner of the facts must assign the relationship to only one category.

A scheme is needed that would give numerical values to detailed criteria, which, when aggregated, would assign the contract to one of several groups. It would seem that more precise measures or determiners could be developed. Subsequent studies might be directed to such tasks. The legal-economic relationships created by vertical coordination contracts need much more investigation in depth.

The emphasis in this study was on legal aspects of vertical coordination contracts, although economic relations were brought into the analysis in many places. That only the first steps were taken in legal-economic analysis of vertical coordination contracts should be obvious. The analysis in the last two sections of this chapter is limited to the degree of transfer of various elements of entrepreneurship from the Farmer to the Contractor. Likewise, only the first steps in classifying vertical coordination contracts have been taken. The need for more research in depth is clear. Future research undertakings may involve the following:

1. Emphasis needs to be on completed contracts and how they are carried out in actual operations. Such research should include field studies involving personal interviews with Farmers and Contractors. The parties' attitudes regarding transfer of entrepreneurship are important. Also, insight into how contracts are carried out in actual practice may help to suggest improved provisions in written contracts.

2. Study is needed of modifications of prepared contract forms before the contracts are signed and particularly during their performance. Agreements made subsequent to execution of the contract need to be included in future studies.

3. Although this study stressed the subject-matter input, all inputs need to be included, particularly those furnished by Contractors.

4. The relation of acquiring inputs to financing agriculture needs to be examined, particularly where equity financing is substituted for financing under credit arrangements that conform to conventional credit standards and practices. For instance, what are the differences, if any, in the conditions and cost of credit via conventional

Table 7.--Second approximation of classification of vertical coordination contracts, based on degree of transfer of elements of entrepreneurship from Farmer to Contractor

Transfer of benefits and burdens of entrepreneurship follow tight-control view		Little transfer of entrepreneurship	Transfer of benefits and burdens of entrepreneurship follow classical view	
Virtually completely in hands of Contractor	Shared about equally between Farmer and Contractor		Shared about equally between Farmer and Contractor	Virtually completely in hands of Contractor
I Input decisions Inputs supplied by Contractor, who makes decisions on quantity and quality.	I Input decisions Inputs supplied by or at direction of Contractor at Farmer's cost. Quantity and quality determined jointly.	I Input decisions Input supplied by Farmer, who makes decisions on quantity and quality.	I Input decisions Inputs supplied by or at direction of Contractor at Farmer's cost. Quantity and quality determined jointly.	I Input decisions Inputs supplied by Contractor, who makes decisions on quantity and quality.
II Operational decisions Contractor supervises or performs all important production practices.	II Operational decisions Major decisions made in contract; Contractor may influence minor decisions.	II Operational decisions Made by Farmer, although contract may state general standards.	II Operational decisions Major decisions made in contract; Contractor may influence minor decisions.	II Operational decisions Contractor supervises or performs all important production practices.
III Risk of loss of product Contractor disclaims liability for damages due to his failure to secure extra labor, or failure to harvest, or failure to perform other acts promised in contracts; and Contractor disclaims liability for deterioration in storage or errors of judgment in processing or selling product.	III Risk of loss of product Contractor disclaims liability for damages due to his agents, his delivery determinations, his pest control determinations, his failure to harvest, or other failure to carry out assumed management control.	III Risk of loss of product Farmer bears risk of loss of product.	III Risk of loss of product Risk of loss shared roughly commensurate with respective management control and/or contribution of inputs.	III Risk of loss of product Contractor assumes virtually all risk of loss as consistent with his management control and contributions.
IV Uncertainty of price Price based on gross or net proceeds from sale of processed or unprocessed products; or price determined by Contractor after execution of contract or subject to subsequent adjustment by Contractor.	IV Uncertainty of price Price based on local or remote market on day Farmer selects, but price may include production incentive.	IV Uncertainty of price Farmer sells in usual market or at price based on market.	IV Uncertainty of price Price related to market on day product is delivered, but may have incentive based on production.	IV Uncertainty of price Price is fixed per unit of product (with or without incentive), generally unrelated to price at time of marketing.

Table 7.--Second approximation of classification of vertical coordination contracts, based on degree of transfer of elements of entrepreneurship from Farmer to Contractor--Con.

Transfer of benefits and burdens of entrepreneurship follow tight-control view		Little transfer of entrepreneurship	Transfer of benefits and burdens of entrepreneurship follow classical view	
Virtually completely in hands of Contractor	Shared about equally between Farmer and Contractor		Shared about equally between Farmer and Contractor	Virtually completely in hands of Contractor
V Uncertainty of market Right to reject because of inability to process, because product cannot be profitably harvested or processed, because product insufficient to operate plant, because product does not meet subjective quality standards, or other reasons in Contractor's determination and which cannot be influenced by Farmer.	V Uncertainty of market Right to reject entire product broader than Farmer's control, particularly if portion is infested, if portion does not meet standards, or if foreign materials cannot be removed without heavy expense.	V Uncertainty of market Rights of rejection are those of typical buyer.	V Uncertainty of market Right to reject product not broader than Farmer's control over quality, quantity, delivery, and so on.	V Uncertainty of market No substantial right to reject for quality reasons; Contractor may reject for failure to deliver on time, failure to follow advice, or for other reasons related to Farmer's responsibility.
VI Restrictions on Farmer Farmer may not grow like product for home consumption; and may not sell excess or rejected products.	VI Restrictions on Farmer Farmer may grow like products only for home consumption; may sell excess or rejected products only with Contractor's consent.	VI Restrictions on Farmer No restrictions on Farmer's extra-contract activities.	VI Restrictions on Farmer Restriction on Farmer's right to grow like products if a danger to contract product, but no restriction on right to sell excess or rejected products after contract satisfied.	VI Restrictions on Farmer Denial of Farmer's right to grow like products or to sell excess or rejected products is rationalized by danger to contract product, by payment for his labor, or other form of *quid pro quo*.

means as compared with vertical coordination contracts?

5. Dissociation of the transfer of entrepreneurial management and control from the benefits and burdens of entrepreneurship needs to be analyzed, particularly any shifts from the conventional situation that existed before any vertical integration took place. Such shifts would be important to anyone concerned with the farmers' freedom in an open-market economy.

6. The analysis should include the competitive position of the two parties and the impact of competition on their economic well-being. This competition may be related to the disparity between transfer of control and receipt of benefits or reduction in burdens.

7. Research is needed to establish the relation of vertical coordination contracts to the introduction of new technology and of supervision under such contracts to the development of managerial acumen. The transfer of management control could have a debilitating effect on the Farmer's ability to manage his own affairs.

8. The development of model contract forms and explanatory material for all important commodities should be an objective of additional research.

FOOTNOTES--CHAPTER 11

[1] See Gene Wunderlich's article, "Measurement of Legal-economic Content of Vertical Integration Contracts in Agriculture", in M.U.L.L., the Journal of the American Bar Association Special Committee on Electronic Data Retrieval, Yale Law School, New Haven, Dec. 1964, pp. 119-126.

[2] Although this criterion encompasses both production and marketing, the author decided it was preferable to include the marketing phase here than to divide the criterion.

APPENDIX: PREPARING THE CONTRACTS FOR ANALYSIS

As stated in chapter 1, contract forms used in this study were obtained from several hundred off-farm initiators of contract arrangements. These forms, in addition to forms furnished by the U.S. Department of Agriculture and Land Grant Colleges, totaled about 900. From these, the authors chose 420 contracts to represent major agricultural commodities produced under vertical coordination contracts in different geographic areas. Not all farm commodities were represented in the sample, but the authors believed that omissions were not serious. For example, although cattle feeding contracts did not appear in a separate listing, they were covered under the general livestock category, and they were similar in many respects to the other livestock feeding contracts, particularly for market hogs and lambs. Also, many kinds of vegetable seed contracts were covered by the general vegetable category, and contracts for production of many kinds of fruits, vegetables, and nuts were included in the several general categories.

Under each contract in the sample, the Contractor participated in at least two of the three phases of production (input, production, and marketing): The off-farm firm furnished the subject-matter input, for example, chicks, seeds, plants, gilts, and so on, from which the final marketable product was produced; the off-farm firm exerted some form of managerial control over part of the onfarm production process, even though the extent and method varied; the off-farm firm assumed some marketing responsibility, that is, it either agreed to purchase the product or undertook some responsibility for selling the raw or processed product.

In reducing the original 900 contracts to the 420 sample number, the authors recognized that some contracts were merely purchase or sales agreements, credit instruments, or agency arrangements. Sales agreements included those contracts executed a few days or weeks prior to delivery, involving only the transfer of a given amount of product on a specific future date. Many contract forms between farmers and feed dealers were for purchases on credit under which the dealer sold feed or other inputs without assuming significant managerial or marketing responsibilities. Some forms represented agreements between farmers and bargaining associations or cooperatives and thus were primarily agency arrangements authorizing the association to negotiate a production or marketing contract, which frequently became the vertical coordination contract between farm and off-farm firms.

Identical or substantially identical forms were excluded from the analytical sample. Some trade associations of processors, suppliers, and other off-farm firms had prepared contract forms for use by their members. Hence, each member of the association used the same contract form or one that was only slightly modified to fit local conditions. Also, patterns of conformity had developed in some instances among several different off-farm firms in particular geographic areas or for particular commodities. Finally, numerous examples were found where a firm used substantially the same contract form for similar commodities.

Culling Data from the Contracts

After the contracts were selected, the next step was to arrange the fact data in a form usable for legal-economic analysis. To reduce the diverse content of the numerous contract provisions to manageable proportions, the authors first designed a data schedule (1) to assist in extracting from the contracts the legal and economic fact data pertinent to subsequent analysis and (2) to provide the structural organization for describing the various terms of each contract individually and, ultimately, in the aggregate.

Ideally, a tool designed for fact accumulation should cull from the contracts the bare factual data without coloration by technical or special terms, or by expressions used in either law or economics. The authors made every effort to limit the

scope of the fact-gathering schedule to the recording of facts, and to exclude any legal or economic implications or judgments based upon the facts. The goal could not be totally accomplished.

In the first place, contracts use legal words for which no satisfactory substitutes have been found--words which have built-in meanings; for example, partner, independent contractor, bailee, assigns, title, and waiver. Warranties, security devices, risk, and uncertainty are other professionally oriented terms that had to be used.

Arrangement of the Data

Reviewing the content of many contracts and of recent literature will suggest some of the difficulties of preparing a schedule to encompass contracts differing in commodity, geographic area, and to a limited extent, purpose. Prior efforts to classify or differentiate vertical coordination contracts, for example, concentrated on geography, commodity, jurisdiction, or purpose. Although these classes may create meaningful distinctions for limited purposes, they conceal similarities and differences of legal and economic relationships between the contracting parties. For example, no distinction in title conceptions need be made because a contract is for broiler production rather than tomato production, or in market uncertainties because the contract is for the production of broilers rather than the bailment of livestock.

To spotlight differences and similarities, the authors found it necessary to envision the various legal and economic issues that contracts might raise and then to determine the possible resolutions of such issues. A survey of past adjudication was also helpful.

A further problem involved the means of recording ideas, with numerous variations in phrasing, that appeared in a mass of contracts. The schedule had to provide a choice of phrases to describe each provision, and the number of phrases provided had to be small enough to be practically usable, yet large enough to encompass all of the possible provisions in the contract universe.

In brief, the data-collating tool had to meet three criteria: it needed (1) to withdraw from the contracts all essential data in summary form, (2) to permit comparison and correlation of provisions within and among contracts, and (3) to provide the necessary index to find the exact words or phrases used in a contract when these were important in the analysis.

As a simple example, consider one legal and economic subject often involved in production contracts--the standards of husbandry demanded of the Farmer in performing his duties under the contract. Virtually all contract forms purporting to establish such standards had some variation in language, yet all were concerned with a fundamental conception. Two major patterns appeared: Some contracts referred to the responsibility in highly generalized terms, for example, "farmerlike manner"; and other contracts laid out highly detailed standards of responsibility.

The contract forms were assembled by commodities and geographical areas, but the analysis was not centered on either commodity or geographic class; rather, it was conducted in terms of the incidence of characteristics, attributes, or traits.

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